



Keeping the Books

California's Budget, Financial and Performance Review

California Performance Review
June 30, 2004

California Performance Review

Bringing California Back

Accountability



June 30, 2004

Chon Gutierrez
Executive Director
California Performance Review
1102 Q Street, Suite 6100
Sacramento, CA 95814

Dear Mr. Gutierrez:

As members of the California Performance Review (CPR), we are pleased to present our final report – Keeping the Books: California's Budget, Financial and Performance Review.

In accordance with Generally Accepted Government Auditing Standards (GAGAS), we conducted an attestation engagement to report the results of a set of agreed-upon procedures as determined by the audit team and CPR. These procedures, detailed in the report, covered the areas of financial systems and reporting, budgetary processes and controls, performance measurement systems and uses, and state oversight of its fiscal affairs. Under this type of review, the auditor gathers and assesses data, but is not required to provide conclusions, findings or recommendations. However, in this case, we have drawn conclusions to be of assistance to the CPR effort, and we present them and our recommendations in the body of the report.

Our approach included interviews of state fiscal and administrative management, surveys of audit and fiscal officers, research of historical budgetary and cost data, and analysis/synthesis of a wide range of source material, primarily that used to record and report state operations. We present our report to CPR Executive Management for its information and use. This report is not intended for and should not be used by anyone other than the specified party. However, its distribution is not restricted for any other reason.

Sincerely,

A handwritten signature in black ink, appearing to read "Rich B. Smith", with a long horizontal flourish extending to the right.

Richard Bon Smith, CPA, CGFM
California Performance Review



Table of Contents

	Page
Introduction and Summary of Findings	1
I. Independent Auditor's Report on Agreed-Upon Procedures	9
II. Budget Review	11
III. Financial Review	47
IV. Performance Review	69
V. Appendices	85



Introduction and Summary of Findings

California's financial house must be put in order so that the state can move forward.

Governor Schwarzenegger called for a line-by-line audit of the state's fiscal operation for precisely that reason. CPR created an audit team to perform such a review in accordance with Generally Accepted Government Audit Standards (GAGAS). California's condition, for this audit, was viewed as if it were a business entity being acquired. Taken in combination with the CPR report, the audit report establishes the "line-by-line" framework and sets the stage for the state oversight function's continuing duty to monitor and assess program performance. The review examined three areas: budget, finances, and performance. The descriptions of the review and summary findings areas follow:

Budget Review Description

- Provide an overview of the state's budget process—from budget development, through enactment, appropriation, mid-year adjustments, total expenditures, deficiencies and future period activities.
- Identify and assess the mid-year appropriation adjustment process when revenue projections and other funding sources vary from estimates.
- Display historical data and trend analysis of state revenues, expenditures and encumbrances for the past five FYs 1998–1999 to 2002–2003.
- Display historical data on state operations and the state's balance sheet to identify the amount of, and to determine reasons for deficiency funding.

Budget/Revenue and Expenditure Review Results

General Fund Fiscal Activity Summary (Percents based on actual amounts, not rounded amounts shown here.)

- General Fund ending balance decreased by \$11.4 billion from \$3.9 billion in FY 1998–1999 to (negative) –\$7.5 billion in Fiscal Year (FY) 2002–2003. The ending balance reached \$9.6 billion in FY 1999–2000.
- General Fund expenditure increases outpaced revenue increases by 285 percent—expenditures increased by \$20.3 billion, while revenues increased by \$7.1 billion.
- Operating deficits in FYs 2001–2002 and 2002–2003 totaled \$24 billion (\$12.5 billion in FY 2001–02 and \$11.5 billion in FY 2002–03).
- The operating deficits were funded by temporary borrowing and transfers and the \$12.2 billion Economic Recovery Bonds issued in 2004.

General Fund Revenues

- General Fund revenues increased by \$7.1 billion (12.1 percent) from FY 1998–1999 to 2002–2003.
- From FY 1998–1999 to 2000–2001, revenues increased by \$18.7 billion (31.7 percent) while from FY 2001–2002 to 2002–2003 revenues fell by \$11.6 billion (14.9 percent).
- Revenue growth in FY 1999–2000 and 2000–2001 was primarily caused by an increase in tax revenues from stock market driven sources such as capital gains, stock options and dividends.
- Revenues returned to more typical levels, such as in FY 1998–1999, when stock market driven revenue sources diminished beginning in FY 2001–2002.

General Fund Expenditures

- From FY 1998–1999 to 2002–2003, General Fund expenditures increased by \$20.3 billion (35.4 percent) from \$57.3 billion in FY 1998–1999 to \$77.6 billion in FY 2002–2003.
- The surge in General Fund revenue in FY 1999–2000 to 2000–2001 drove the increase.
- General Fund expenditures have increased by \$3.5 billion for state operations and \$16.9 billion for local assistance, but decreased by \$0.1 billion for capital outlay.
- For five of the six entities with the largest expenditure growth, the majority of the increased funding was provided for local assistance entitlement programs.

Top Six Expenditure Analysis

- Six state departments/functions accounted for \$15.2 billion or 75.1 percent of the \$20.3 billion General Fund expenditure increase, as follows:
 - Department of Education \$4.1 billion
 - Tax Relief/ Aid to Local Government \$4.0 billion
 - Department of Health Services \$3.2 billion
 - Department of Social Services \$1.8 billion
 - Department of Developmental Services \$1.2 billion
 - Department of Corrections \$0.9 billion
- Details of the increases are presented in the body of the report.

General Fund Deficiencies

- Deficiencies account for a small percentage of total General Fund expenditures and were not a material factor to the operating deficits of FY 2001–2002 and 2002–2003.
- From FY 1998–1999 to 2002–2003, deficiencies account for 0.5 percent to 1.7 percent of total General Fund expenditures ranging from a low of \$0.4 billion in FY 2000–2001 to a high of \$1.3 billion in FY 2002–2003.
- Four departments have recurring deficiencies: Health Services, Corrections, Developmental Services and Forestry and Fire. These four departments accounted for



\$3.3 billion (84.9 percent) of the total \$3.9 billion deficiencies from FY 1998–1999 to 2002–2003.

General Fund Encumbrances

- From FY 1999–2000 to 2002–2003, General Fund unliquidated encumbrance balances increased by \$0.3 billion (47.9 percent) from \$0.7 billion in FY 1999–2000 to \$1 billion in FY 2002–2003.
- From FY 1999–2000 to 2000–01, unliquidated encumbrance balances increased by \$1.1 billion (161.6 percent) to a total of \$1.8 billion.
- From FY 2001–2002 to 2002–2003, the balance was reduced by \$0.8 billion (43.4 percent) to \$1 billion.

General Fund Budgeted vs. Actual Expenditures

- The state's fiscal control system does not allow departments to exceed spending authority (that is, if the appropriation runs out, a deficiency must be obtained).
- From FY 1998–1999 to 2002–2003, General Fund expenditures increased consistently with spending authority increases. General Fund expenditures have increased by \$20.3 billion while the state's spending authority has increased by \$21.3 billion.
- From FY 1998–1999 to 2002–2003, the state has spent an average of 97.9 percent of its spending authority.
- Reducing the spending authority by the total amount of deficiencies, the state has spent an average of 98.9 percent of its spending authority, exceeding it only in FY 1998–1999.

Financial Review Description

- Assess whether state agencies have effective systems of internal control to help detect errors and to help prevent fraud or waste.
- Verify assurances that state agencies' financial information is timely, reliable and fairly stated—the external reporting.
- Assess whether timely, accurate and appropriate financial information is available to program managers—the internal reporting.
- Validate that Chief Financial Officers have an adequate basis to attest to their financial statements' fair presentation.

Financial Review Results

California's System of Internal Controls and Monitoring Should Be Improved

- Many state agencies have neglected to comply with the applicable law requiring effective systems of internal controls. Consequently, the risk of fraud, waste and abuse is increased for the individual agencies and for the state as a whole.
- Additionally, the agencies, without adequate oversight may produce misstated financial statements and not be aware of the extent of the misstatement.
- Many of the state agencies required to complete internal control audits do not do so, nor do they complete required certifications as to the accuracy of their internal controls'

effectiveness. The required audits frequently identify deficiencies related to accounting and administrative controls.

- For the most part, management takes corrective action to fix identified deficiencies, but items continue to be reported from year to year. The continued internal control deficiencies could suggest that the audit function is not at the proper organizational level to effectively change the state's control environment.
- The Financial Integrity and State Manager's Accountability Act is being ignored by many state agencies; monitoring efforts are ineffective to ensure compliance.
- Internal auditors identified many control deficiencies that management appropriately corrects. However, systematic problems may exist.

Many smaller state agencies' financial information is not being adequately reviewed to determine if it is reliable and fairly stated

- Numerous smaller agencies do not receive routine audits of their financial information as is typically performed on larger departments. The Bureau of State Audits (BSA) annual audit of the state's financial statements will rarely include smaller agencies because of its high materiality audit levels.
- Most state agencies do not have internal audit units and are unable to perform routine accounting/administrative control audits. Control agency audits typically are directed at agencies with high expenditure amounts.
- Sometimes, a department's only financial statement review comes from the State Controller's Office (SCO), but that review is more form than substance. Nevertheless, these reviews identified problems with many agencies financial reports' timeliness and with the accuracy of financial data. Given these conditions, we believe the state is at risk of unreliable financial information being prepared by smaller agencies.

Financial System Review

- The large number of existing financial systems is not efficient or effective.
- The existing systems lack sufficient oversight or audit.
- Many existing systems are obsolete due to deferred maintenance.
- The state is dependent on diminishing staff resources to maintain and operate its systems and to ensure data integrity.
- The decentralization of the state's systems has created a risk (no complete, accurate centralized inventory of fiscal systems exists).
- Systems' design limits their use and increases maintenance (especially for systems that co-mingle accounting and program functionality).
- State laws, regulations and policies have requirements that are so complicated, standard commercial off-the-shelf software is frequently not applicable or requires customization.
- Organizationally, the state lacks a clear definition as to who is accountable for financial management and related systems (individual departments, Department of Finance, (DOF) SCO, State Treasurer's Office, the state's Chief Information Officer).



- The state lacks a strategic direction for financial management and related systems, and currently has no plan to get there.

Performance Review Description

- Assess the applicability and enforcement of strategic planning/performance-based budgeting, Government Code Sections and Department of Finance Budget Letter 98-07.
- Determine levels of compliance, i.e., the extent to which Agencies, Departments, Boards, Commissions, or Offices are preparing and using strategic plans.
- Assess effectiveness of agencies' strategic planning efforts and whether adopted performance measures are useful to measure agency performance (outcome/results-oriented rather than output measures).
- Review other audits of agencies' strategic plans and/or performance measures, assess the results, and analyze the level of statewide audit coverage of strategic planning/performance-based budgeting processes.

Performance Review Results

Department of Finance's Oversight of Activities

- No centralized tracking/monitoring of statewide strategic planning efforts exists.
- The Legislature authorized a performance budgeting pilot in 1993, but that effort has been largely abandoned.

Survey of Strategic Planning/Performance Based Budgeting

One hundred and six agencies were surveyed and 80 responses received (75.5 percent). Summary results follow:

Strategic Planning

- Majority of agencies perform some type of strategic planning.
- Half of reporting agencies use internal staff to develop strategic plans.
- Most agencies provide training on strategic planning, but don't use the State Training Center (which provides some guidance).
- Most agencies prepare strategic plans but don't forward them to DOF or submit them to the Governor's Office.
- Annual costs (unaudited) associated with strategic planning varied greatly, but averaged \$57,000.
- Less than half of the agencies responding indicated that their plans tie to an overall plan.
- An existing "Strategic Planners Group" is not well known among state agencies.
- Biggest obstacle to strategic planning is a lack of resources.

Performance Measurement

- Eighty-eight percent of responding agencies are currently using benchmarks/performance measures.
- Most agencies have processes in place to gather/measure data.
- Performance results are regularly monitored by agency management teams.
- Agencies analyze and adjust measures and integrate changes into plans.
- Insufficient resources and inability to develop performance measures often derail efforts to establish/fine-tune performance measures.
- Agencies use of performance measures improved their focus on strategic goals and objectives.

Performance Based Budgeting (PBB)

- Twenty-four percent of responding agencies have integrated performance into their budgeting processes.
- Most agencies budgetary responsibilities are established and regularly monitored.
- Lack of resources precludes agencies from implementing a PBB process.

Audit Coverage Over Agencies' Strategic Planning and Performance Measuring

- Nearly half of the reporting agencies indicated that their program performance or measures were reviewed or audited.
- The BSA identified needed improvements in strategic planning and performance measurement.
- Some state agencies' internal auditors conduct performance reviews of operations and programs, including assessment of performance measurement.
- The DOF's evaluation of the performance-based budgeting pilot's preliminary results was favorable.
- The state needs centralized control for successful oversight, guidance and monitoring.

Audit Resources

- Approximately 60 departments employ nearly 4,000 auditors, evaluators and examiners in 90 different, distinct classifications, many with similar entry requirements and pay scales. Given the similarities, the many different classifications may not be necessary or useful.
- No separate civil services classification exists for IT auditor (apart from separate series restricted to the Bureau of State Audits and Public Employees Retirement System).
- Little coordination between state entities and among the audit units encourages inefficiency in resource allocation.
- Most audit units cite auditing standards; few have had peer reviews as required by the standards.



The following sources and information were used to conduct this audit:

Financial Condition Reporting Methods

The state reports its financial condition in three separate and distinct documents:

- Governor's Budget Summary (GBS)
 - SCO Budgetary Legal Basis (SCO BLB) Annual Report
 - SCO Comprehensive Annual Financial Report (CAFR)
- For 2002–2003, these documents report General Fund ending balances of:

Governor's Budget Summary	\$1.6 billion
SCO BLB Annual Report	–\$7.5 billion
SCO CAFR	–\$13.3 billion

The differences include:

\$9.2 billion in bond proceeds recognized by the GBS which is not recognized by the SCO BLB.

\$5.8 billion difference between the SCO BLB and CAFR primarily consists of interfund payables (\$2.1 billion) and liabilities budgeted in subsequent years (\$3 billion).

- Government Code Section 12460 states that the Generally Accepted Accounting Principles basis reporting is the preferred method, which minimizes the opportunity for manipulating financial data to influence fiscal reporting.

In addition, the state's audit community was surveyed to identify the extent and use of audit resources. To supplement the Budget Review information, a methodology was developed to drill down to the object of expenditure (i.e., salaries and wages, consultants, retirement, etc.) level for most of the entities that experienced the largest expenditure growth for FYs 1998–1999 through 2002–2003.

The following review concentrated its efforts on those broad fiscal policy issues—fiscal management and processes, budgetary control and trends, performance measurement and experience—which cut across all agencies and determine the state's ability to interact internally and with the public.

The Budget Review provides an overview of the state's budget process—from budget development, through enactment, appropriation, mid-year adjustments, total expenditures, deficiencies and future period activities. The analysis includes historical data and trend

analysis of state revenues, expenditures and encumbrances for the past five FYs 1998–1999 to 2002–2003, as well as historical data on state operations and the state’s balance sheet to identify the amount of, and reasons for deficiency funding. To perform the analysis, a “line-by-line” assessment of budget appropriations and limited “drill-down” into individual items was included. Further, the mid-year appropriation adjustment process was reviewed to show the effects when revenue projections and funding source collections vary from estimates. This section’s conclusions highlight the difficulties in data manipulation for fiscal comparisons and show those areas/entities largely responsible for expenditure growth over a five-year period.

The Financial Review assesses whether state agencies have effective systems of internal control to help detect errors and to help prevent fraud, waste and abuse. The review included a survey of the state’s internal auditors and their impact on the control environment. Additionally, individual state agencies’ externally reported financial information (financial statements) was reviewed for timeliness, reliability and fair presentation. Further, agencies’ systems designed to provide timely, accurate and appropriate financial information to program managers—the internal reporting—were evaluated. The evaluations of these systems and reporting mechanisms provided a basis to assess whether Chief Financial Officers have an adequate basis to attest to their financial statements’ fair presentation. The report conclusions identify opportunities for increased efficiency and economy.

The Performance Review identifies historic applicability and enforcement of strategic planning/performance-based budgeting and levels of compliance currently in existence. State entities were surveyed regarding their preparation and use of strategic plans. Moreover, the effectiveness of strategic planning efforts and whether adopted performance measures are useful to measure department performance (outcome/results-oriented rather than output measures) are included in this section. The discussion includes other audits of strategic plans and/or performance measures to assess results, and analyzes the level of statewide audit coverage of strategic planning/performance-based budgeting processes. Conclusions present strategies for future development and expansion of the premise.

Additionally, an interest in the function and utility of the audit function statewide lead to the inclusion of comments regarding the distribution and coordination of audit resources throughout the state. This section surveys the many audit related classifications, personnel numbers and expenditures, and highlights some departments’ experiences with external auditors.

The Audit Team relied directly on the work of the Bureau of State Audits, the State Controller’s Office, the Department of Finance and the Department of Personnel Administration, and on survey input from the state’s internal auditors, financial, budget and information officers.



Independent Auditor's Report on Agreed-Upon Procedures

The California Performance Review (CPR) Audit Team set out to define the concept of a “line-by-line” audit, to determine how to approach it, and finally to complete the audit work necessary to report it. Appendix I discusses the “line-by-line” concept in greater detail. This report details how we believe the state can address the “line-by-line” audit through its ongoing monitoring and control functions. The Audit Team’s findings are detailed below. The review was conducted in accordance with generally accepted government auditing standards (GAGAS) applicable to attestation engagements. We performed the agreed-upon procedures listed below to provide information and analysis to CPR and to assist the CPR effort. The sufficiency of the procedures is solely the responsibility of CPR management. Consequently, we make no representation as to the procedures’ sufficiency for the purpose of the report or for any other purpose.

Agreed-upon procedures:

Budget Review—

- Provide an overview of the state’s budget process—from budget development, through enactment, appropriation, mid-year adjustments, total expenditures, deficiencies and future period activities.
- Identify and assess the mid-year appropriation adjustment process when revenue projections and other funding sources vary from estimates.
- Display historical data and trend analysis of state revenues, expenditures and encumbrances for the past five FYs, 1998–1999 to 2002–2003.
- Display historical data on state operations and the state’s balance sheet to identify the amount of, and to determine reasons for, deficiency funding.

Financial Review—

- Assess whether state agencies have effective systems of internal control to help detect errors and to help prevent fraud or waste.
- Verify assurances that state agencies’ financial information is timely, reliable and fairly stated—the external reporting.
- Assess whether timely, accurate and appropriate financial information is available to program managers—the internal reporting.
- Validate that chief financial officers have an adequate basis to attest to their financial statements’ fair presentation.

Performance Review—

- Assess the applicability and enforcement of strategic planning/performance-based budgeting Government Code Sections and Department of Finance Budget Letter 98-07.
- Determine levels of compliance, i.e., the extent to which Agencies, Departments, Boards, Commissions, or Offices are preparing and using strategic plans.
- Assess effectiveness of agencies' strategic planning efforts and whether adopted performance measures are useful to measure agency performance (outcome/results oriented rather than output measures).
- Review other audits of agencies' strategic plans and/or performance measures; assess the results; and analyze the level of statewide audit coverage of strategic planning/performance-based budgeting processes.

In addition, we surveyed the state's audit community to identify the extent and use of audit resources. To supplement the Budget Review information, we have developed a methodology to drill down to the object of expenditure level for most of the entities that experienced the largest expenditure growth for FYs 1998–1999 through 2002–2003.



Budget Review

State Budget Process

State entity annual spending plans, or budgets, begin with agencies, departments, boards and commissions submitting Supplementary Schedule of Appropriations (Schedule 10) and Supplementary Schedule of Revenues and Transfers (Schedule 10R) to the Department of Finance (DOF). These schedules include actual revenues and expenditures for the most recent completed fiscal year (past year), revenues and expenditures estimates for the current year (current year) and proposed revenues and expenditures for the upcoming budget year (budget year).

DOF budget analysts review the data and compile the information into the past, current and budget year format as presented in the annual Governor's Budget. As the budget data are compiled and reviewed, the Governor, through DOF, modifies the budget to reflect his policy emphasis.

Budget year proposed amounts are based on the current year's budget, with changes to the base budget made through Budget Change Proposals (BCP). BCPs are developed by department staff and are submitted to the department directors for approval. Directors may approve, deny, or modify BCPs before forwarding them to the agency secretary, if applicable, for approval. BCPs are further reviewed by the agency secretary who may modify, approve, or deny them. BCPs approved by the director and agency secretary are submitted to DOF for review.

After receiving and reviewing BCPs, DOF may question the department about its budget changes, their effects on programs and their fiscal impacts. Approved BCPs are incorporated into the Governor's Budget as modifications to the department's budget. The Governor's Budget proposal is submitted to the Legislature by January 10th each year.

In addition to BCPs, DOF, acting as the Governor's chief fiscal advisor, analyzes all legislation and any other proposals that may affect the state's fiscal condition and policies.

The Legislative Analyst Office (LAO) reviews the Governor's Budget proposal and submits its analysis to the Legislature. LAO's analysis provides further scrutiny and commentary on the Governor's spending plan and assumptions.

From January through May, DOF continues its analysis and refines the budget by collecting updated information and honing projected revenues and expenditures. Each year, by May 14,

the Governor submits to the Legislature proposed changes to the January Budget in the May Revision. The May Revision includes updated General Fund revenue estimates, changes in Proposition 98 (school) funding, and caseload, enrollment and population adjustments.

Each House of the Legislature scrutinizes and deliberates the spending plan in budget subcommittees. The Legislature holds budget hearings, and questions department and DOF representatives about the proposed budgets. LAO representatives also provide input and commentary during these hearings. Program stakeholders may also participate in the hearings and voice their views on various state policies and programs.

Each House of the Legislature modifies the Budget to reflect their program and policy emphasis. Each House then approves its version of the Budget, and the two versions are moved to a Conference Committee to resolve the discrepancies. After both Houses approve the Budget with a two-thirds vote, the Budget Bill is moved to the Governor for signature. Prior to signing the bill, the Governor can veto items he does not want included in the final spending plan.

Once the Governor signs the Budget Act, the State Controller's Office (SCO) and each department inputs the authorized spending plan into their accounting systems and begins posting expenditures in accordance with the Budget Act.

The budgetary deliberative process provides significant opportunities for discussion of program effectiveness and necessity.

Note that throughout our analysis, percentages reported are based on the actual amounts from identified source material.

General Fund Fiscal Activity Summary

State fiscal activity is accounted for in sets of separate self-balancing accounts called funds. The General Fund is principal among them, and is significant because it accounts for the traditional state revenue sources, e.g., personal income tax, and is the primary funding source for most state expenditures. Approximately three-fourths of the state's operating expenditures are funded by the General Fund; therefore, the state's fiscal condition and ability to provide services relies heavily on the condition of the General Fund.

The state also maintains non-governmental cost funds, which include bond funds, trust and federal funds, public service enterprise funds, working capital and revolving funds, and retirement funds. These funds derive their revenue from sources other than general and special taxes, licenses, fees and other state revenues.

The SCO, Fiscal Year (FY) 2002–2003 Budgetary/Legal Basis Annual Report discloses the General Fund ended the year with a fund balance of (negative) –\$7.5 billion; however, all the



other Governmental Cost Funds maintained a positive ending balance. Given the General Fund's condition and its affect on the state's fiscal condition, we focused our analysis on the General Fund.

The General Fund ending fund balance decreased a total of \$11.4 billion from \$3.9 billion at June 30, 1999 to (negative) -\$7.5 billion at June 30, 2003 as a result of operating deficits in FYs 2000–2001 through 2002–2003. Exhibit 1 summarizes General Fund activity and condition for the past five fiscal years.

Exhibit 1
General Fund
(dollars in thousands)

	1998–99	1999–00	2000–01	2001–02	2002–03
Beg. Fund Balance	\$2,792,484	\$3,907,671	\$9,639,691	\$9,017,521	–\$2,109,760
Prior Period Adj.	15,155	12,517	–388,736	–512,430	528,630
Revenues	58,935,144	71,555,636	77,609,900	64,060,309	66,060,736
Expenditures	<u>–57,271,883</u>	<u>–66,103,712</u>	<u>–78,127,372</u>	<u>–76,551,184</u>	<u>–77,564,277</u>
Operating Surplus/Deficit	1,663,261	5,451,924	–517,472	–12,490,875	–11,503,541
Transfers In	93,878	423,302	6,561,817	2,143,250	3,289,521
Transfers Out	–996,571	–203,818	–6,324,088	–301,158	–369,955
Other Funding Sources	<u>339,464</u>	<u>48,095</u>	<u>46,309</u>	<u>33,932</u>	<u>2,628,870</u>
Ending Fund Balance	<u>\$3,907,671</u>	<u>\$9,639,691</u>	<u>\$9,017,521</u>	<u>–\$2,109,760</u>	<u>–\$7,536,235</u>

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports 1998–1999, 1999–2000, 2000–2001, 2001–2002 and 2002–2003.

Note: The SCO includes \$2.5 billion in tobacco bond proceeds as revenue in FY 2002–2003; however, we include the funding in Other Funding Sources.

As illustrated, revenues exceeded expenditures in FYs 1998–1999 and 1999–2000, resulting in the ending fund balance increasing to \$9.6 billion. Revenue and expenditures were relatively equal in FY 2000–2001; expenditures exceeded revenues by \$517.5 million. The \$517.5 million operating deficit was funded with prior year fund balance.

After positive aggregate operations in FYs 1998–1999, 1999–2000 and 2000–2001, the state incurred an operating deficit of \$12.5 billion in FY 2001–2002. The deficit was primarily funded by the \$9 billion beginning fund balance and \$2.1 billion in transfers from other funds; however, these sources were insufficient to overcome the operating deficit. As a result, the General Fund ending balance at June 30, 2002, was (negative) –\$2.1 billion. After exhausting internal borrowing resources, SCO issued \$5.7 billion in Revenue Anticipation Notes (RAN) maturing in June 2002, in order to meet the state's cash needs. In June 2002, SCO issued \$7.5

billion in Revenue Anticipation Warrants (RAW) in order to meet the state's cash needs in early FY 2002–2003. Although the state was able to meet expenses with short-term borrowing, the \$2.1 billion funding deficit remained and was carried forward into FY 2002–2003.

Revenues increased from \$64.1 billion to \$66.1 billion from FYs 2001–2002 to 2002–2003, but were not sufficient to fund expenditures, which increased from \$76.6 billion to \$77.6 billion in the same period. As a result, the state incurred another operating deficit totaling \$11.5 billion. This deficit would have been approximately \$2 billion greater if not for the deferral of Education funding into FY 2003–2004.

As a result of FY 2001–2002 deficit carry forward and the FY 2002–2003 operating deficit, the General Fund closed the year with a fund balance of (negative) –\$7.5 billion. Similar to FY 2001–2002, SCO issued \$12.5 billion in RAN maturing in June 2003 and issued \$11 billion in RAW in order to retire the \$12.5 billion in RAN and to meet fiscal obligations in early FY 2003–2004.

While the state was able to meet its immediate cash needs using RAN and RAW, the state planned on issuing long-term bonds in order to fund the operating deficit. Specifically, the state proposed issuing \$9.2 billion in Fiscal Recovery Bonds in FY 2002–2003. However, legal challenges stopped the bond issuances on the basis they violated the State Constitution, which limits the state from incurring debt beyond \$300,000 without voter approval. As a result, the state's cumulative operating deficit of \$7.5 billion was carried forward to FY 2003–2004.

Although the state did not realize revenue from the proposed bonds in FY 2002–2003, it did realize \$2.5 billion from Tobacco Settlement Revenue Bonds. In 1998, California and other states signed a Master Settlement Agreement with the four major tobacco companies. The agreement required the tobacco companies to make annual payments (tobacco assets) to the state in perpetuity. Chapter 414, Statutes of 2002, authorized the state to sell the tobacco assets in an amount necessary to provide the state up to \$4.5 billion. In January 2003, the state deposited \$2.5 billion in tobacco bond proceeds into the General Fund; moreover, Chapter 225, Statutes of 2003, increased the authorized bond issuance from \$4.5 billion to \$5 billion allowing the state to receive another \$2.3 billion in tobacco bond proceeds in September 2003.

In March 2004, California voters approved the California Economic Recovery Bond Act (Proposition 57), which authorized the state to issue up to \$15 billion in Economic Recovery Bonds (ERB). The state issued \$12.2 billion in ERB in FY 2003–2004 to fund the cumulative operating debt, as well as other obligations; moreover, the state may issue the remaining \$2.8 billion in future years as needed. The ERBs will be repaid by shifting 0.25 percent of the base sales tax designated for local government general purpose use to the state's Fiscal Recovery Fund and ultimately fund ERB debt service.



The large transfers in FY 2000–2001 primarily represent a \$6.2 billion transfer from the General Fund to the Department of Water Resources Electric Power Fund as a result of the 2000 through 2001 energy crisis. Specifically, Chapter 4, Statutes of 2001, authorized the Department of Water Resources (DWR) to enter into contracts and purchase electric power. Furthermore, Chapter 9, Statutes of 2001, authorized DWR to issue bonds up to \$13.4 billion in fulfilling its charge and to repay the General Fund loan. Although SCO accrued the loan repayment in 2000–2001, DWR issued bonds totaling \$11.7 billion in October 2002, at which time the General Fund was repaid with interest. Although the delay in repaying the General Fund affected the state’s cash management, the loan did not cause the state’s FYs 2001–2002 and 2002–2003 operating deficits and resulting cumulative debt.

General Fund Revenue Analysis

General Fund revenues are composed of two broad categories: major and minor revenue. Major revenue primarily consists of personal income tax, sales tax and corporation tax. Minor revenue consists of other lesser taxes, fees, licenses and other revenue sources. These revenues comprise the state’s primary source to fund state expenditures.

As illustrated in Exhibit 2, revenue spiked in FYs 1999–2000 and 2000–2001; however, revenues returned to a more sustainable level in FY 2001–2002.

Exhibit 2
General Fund Revenue
(dollars in thousands)

Revenue	1998–1999	1999–2000	2000–2001	2001–2002	2002–2003
Major Revenue	\$58,198,632	\$70,027,373	\$75,667,541	\$62,654,384	\$64,878,609
Minor Revenue	<u>736,512</u>	<u>1,528,263</u>	<u>1,942,359</u>	<u>1,405,925</u>	<u>1,182,127</u>
Total Revenue	<u>\$58,935,144</u>	<u>\$71,555,636</u>	<u>\$77,609,900</u>	<u>\$64,060,309</u>	<u>\$66,060,736</u>

State Controller’s Office, Budgetary/Legal Basis Annual Reports 1998–1999 through 2002–2003.

FY 2002–2003 minor revenue excludes \$2.5 billion from tobacco bond proceeds.

Although all revenue components increased, the most significant growth occurred in personal income tax revenue. The revenue growth is primarily due to increased tax revenues from stock market driven sources such as capital gains, stock options and dividends. However, once the market driven revenue sources diminished, personal income tax revenue returned to more typical levels. Although personal income tax fluctuated significantly, the other revenue components reflect less dramatic variation and affect on the overall revenue windfall in FYs 1999–2000 and 2000–2001.

As illustrated in Exhibit 3, total operating revenue grew \$7.1 billion (12.1 percent), for the five-year period from FY 1998–1999 through FY 2002–2003. Personal income tax revenue grew 5.9 percent; however, retail sales and use tax reflects the largest sustained dollar growth, \$3.5 billion.

Exhibit 3
Revenue Growth
(dollars in thousands)

Revenue	1998–99	2002–03	Dollar Inc./Dec.	Percentage Inc./Dec.
Major Revenue				
Personal Income Tax	\$30,891,481	32,709,761	\$1,818,280	5.9%
Retail Sales and Use Tax	18,957,484	22,415,138	3,457,654	18.2%
Corporation Tax	5,724,002	6,803,559	1,079,557	18.9%
Insurance Tax	1,253,972	1,879,784	625,812	49.9%
Other Major Revenue	<u>1,371,693</u>	<u>1,070,367</u>	<u>–301,326</u>	–22.0%
Total Major Revenue	58,198,632	64,878,609	6,679,977	11.5%
Minor Revenue	<u>736,512</u>	<u>1,182,127</u>	<u>445,615</u>	60.5%
Total Revenue	<u>\$58,935,144</u>	<u>\$66,060,736</u>	<u>\$7,125,592</u>	<u>12.1%</u>

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports FYs 1998–99 and 2002–03
FY 2002–2003 minor revenue excludes \$2.5 billion from tobacco bond proceeds.

Although most revenue components increased, estate tax revenue decreased resulting in a decrease in Other Major Revenue. The decrease occurred because the state estate tax is linked to the federal estate tax. In 2002, the federal Economic Growth and Tax Reconciliation Act of 2001 (Act) began phasing out the federal estate tax. As a result, state estate tax revenue has begun to decline and will be eliminated in 2005. However, when the Act expires in 2010, the federal and state estate tax could be reinstated.

Overall, minor revenue grew by \$445.6 million (60.5 percent). While various components of minor revenue fluctuated, the increase was largely driven by tobacco settlement proceeds. Specifically, the state deposited \$515 million, \$380 million and \$76 million into the General Fund in FYs 1999–2000, 2000–2001 and 2001–2002, respectively. As previously discussed, the state sold its rights to the settlement payments and received \$4.5 billion in bond proceeds.

Beginning in FY 2000–2001, the state received approximately \$300 million annually in association with child support collections. To receive public assistance in the CalWorks, Foster Care or Medi-Cal programs, custodial parties must trade their right to collect child support payments in exchange for services provided. Child support monies collected from the non-custodial parent(s) are collected by the counties and remitted to the state's General Fund.



Revenue Estimates

Each year, the Governor's Budget includes General Fund revenue estimates based on economic forecast data developed in late November of the prior year. Then, the following May, these revenue estimates are updated and included in the May Revision. The May revenue estimates include updated economic forecast information, including personal income tax revenues collected and estimated first payments due as of April 15th, and form the basis for the General Fund spending plan.

As illustrated in Exhibit 4, the difference between estimated and actual General Fund revenues fluctuated between an \$8.8 billion underestimate in 1999–2000 to a \$10 billion overestimate in FY 2001–2002. Moreover, the \$10 billion overestimate in FY 2001–2002 was followed by an additional \$6 billion overestimate in FY 2002–2003, resulting in a \$16 billion overestimate for the two-year period. The wide estimate swings point to the difficulties posed by single-year budgets.

Exhibit 4
Estimated and Actual Revenue
(dollars in thousands)

Fiscal Year	Estimated Revenues	Actual Revenues	Under/Over Estimate	Percentage Under/Over Estimate
1998–99	\$57,105,911	\$58,935,144	\$1,829,233	3.2%
1999–00	62,719,402	71,555,636	8,836,234	14.1%
2000–01	73,881,280	77,609,900	3,728,620	5.1%
2001–02	74,072,675	64,060,309	–10,012,366	–13.5%
2002–03	72,087,890	66,060,736	–6,027,154	–8.4%

Source: State of California, Department of Finance.

Estimated revenues do not include loans and transfers.

FY 2002–2003 Estimate excludes \$4.5 Billion in Tobacco Bond Revenue.

The difference between estimated and actual General Fund revenue is primarily due to the difficulty in estimating personal income tax (PIT) revenues, which account for almost half of all General Fund revenues. The extreme rise and fall of stock market driven revenue sources in the late 1990s and early 2000s made estimating PIT revenues extremely difficult. As illustrated in Exhibit 5, PIT revenues were underestimated by \$6.7 billion in FY 1999–2000, and overestimated by \$9.1 billion and \$4.9 billion in FYs 2001–2002 and 2002–2003, respectively.

Exhibit 5
Estimated and Actual Personal Income Tax
(dollars in thousands)

Fiscal Year	Estimated PIT	Actual PIT	Under/Over Estimated	Percentage Under/Over Estimated
1998–99	\$28,963,000	\$30,891,481	\$1,928,481	6.7%
1999–00	32,914,000	39,574,650	6,660,650	20.2%
2000–01	41,333,000	44,614,298	3,281,298	7.9%
2001–02	42,143,500	33,046,665	–9,096,835	–21.6%
2002–03	37,625,000	32,709,761	–4,915,239	–13.1%

Source: State of California, Department of Finance (Estimated Revenue at Budget enactment)

Further compounding the overstated revenue estimates in FYs 2001–2002 and 2002–2003, is the state’s pattern of enacting spending plans that exceed the revenue estimates. As illustrated in Exhibit 6, estimated budget expenditures exceeded estimated revenues every year for the period FYs 1998–1999 through 2002–2003, resulting in a total estimated deficit of \$15.4 billion.

Exhibit 6
Estimated Revenue and Estimated Expenditures
At Budget Enactment
(dollars in thousands)

Fiscal Year	Revenue Estimates	Expenditure Estimates	Estimate Deficit
1998–99	\$57,105,911	\$57,262,200	– \$156,289
1999–00	62,719,402	63,732,900	– 1,013,498
2000–01	73,881,280	78,815,900	– 4,934,620
2001–02	74,072,675	78,763,400	– 4,690,725
2002–03	<u>72,087,890</u>	<u>76,721,700</u>	<u>– 4,633,810</u>
Total	<u>\$339,867,158</u>	<u>\$355,296,100</u>	<u>– \$15,428,942</u>

Source: State of California, Department of Finance.

Revenue Estimates at Budget Enactment exclude loans and transfers.

Revenue Estimate for FY 2002–2003 excludes \$4.5 billion in estimated Tobacco Bond Proceeds.



Most of the anticipated funding gaps for FYs 1998–1999 through 2001–2002 were to be funded by accumulated savings, or fund balance. The only budget that did not rely on using fund balance was in FY 2002–2003, which identified one-time revenue of \$4.5 billion from the Tobacco Settlement Revenue Bonds. However, as noted, only \$2.5 billion was realized in FY 2002–2003.

Mid-Year Spending Adjustments

When estimated revenues fell \$16 billion short of actual revenues in FYs 2001–2002 and 2002–2003, the state enacted mid-year spending reductions. Exhibit 7 illustrates various mid-year solutions enacted, resulting in \$3.2 billion and \$3.3 billion savings in FYs 2001–2002 and 2002–2003, respectively. We combined source information from DOF in the exhibit.

Approximately half of the \$3.2 billion in FY 2001–2002 mid-year savings resulted from loans, fund shifts, federal funding increases, accelerations/transfers, fund sweeps and other actions. For FY 2002–2003, the Administration requested mid-year savings of \$5.6 billion, but achieved \$3.3 billion, including reversions, cuts and funding redirections, and relying heavily on savings generated in education funding. Education solutions in FY 2002–2003 included \$1.3 billion in deferrals, \$0.7 billion in fund shifts and reversions, \$0.4 billion in K–12 reductions and \$0.2 billion in community college reductions.

Exhibit 7
Mid-Year Budget Reductions
(dollars in thousands)

	2001–02	2002–03
Legislative, Judicial and Executive	\$75,317	\$50,750
State and Consumer Services	44,000	16,382*
Business, Transportation and Housing	301,900	167,908
Technology, Trade and Commerce	7,957	13,479
Resources	127,712	150,456
Environmental Protection	44,000	8,764
Health and Human Services	211,340	255,627
Youth and Adult Correctional	6,147	15,345
Education	1,404,843	2,565,566
Labor and Workforce Development	0	8,176
General Government	446,286	85,005
Other	545,950	0
Total	\$3,215,452	\$3,337,458

Source: State of California, Department of Finance.

* Agency total net of revenue offsets.

Although the mid-year reductions were made, they failed to match the revenue declines. As a result, the state incurred operating deficits of \$12.5 billion and \$11.5 billion in FYs 2001–2002 and 2002–2003, respectively, as discussed in the General Fund Fiscal Activity Summary above.

General Fund Expenditure Analysis

For the five-year period FYs 1993–1994 through 1997–1998, General Fund expenditures grew from \$38.9 billion to \$53.1 billion (36.6 percent). Similarly, for the period FYs 1998–1999 through 2002–2003, General Fund expenditures increased from \$57.3 billion to \$77.6 billion (35.4 percent). For a detailed listing of department expenditure changes, see Appendix II. However, unlike the balanced expenditure and revenue growth from FYs 1993–1994 to 1997–1998, revenue growth did not match expenditure growth in FYs 1998–1999 through 2002–2003, which resulted in the operating deficits in FYs 2001–2002 and 2002–2003.

As Exhibit 8 illustrates, State Operations expenditures increased \$3.5 billion, while Local Assistance grew \$16.9 billion from \$42.3 billion to \$59.2 billion. State Operations are expenditures that support State government activities, excluding capital outlay projects. Local Assistance generally supports local government activities; however, it may also encompass support for local non-profit activities, such as the regional centers that fund and coordinate services for the developmentally disabled.

Exhibit 8
General Fund Expenditures
By Character
(dollars in thousands)

Character	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Dec.	Percentage Inc./Dec.
Expenditures				
State Operations	\$14,775,839	\$18,277,646	\$3,501,807	23.7%
Local Assistance	42,260,347	59,145,293	16,884,946	40.0%
Capital Outlay	<u>235,697</u>	<u>141,338</u>	<u>–94,359</u>	<u>–40.0%</u>
Total Expenditures	<u>\$57,271,883</u>	<u>\$77,564,277</u>	<u>\$20,292,394</u>	<u>35.4%</u>

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports, FYs 1998–1999 and 2002–2003.

Although expenditures increased by a net \$20.3 billion, 98 departments and activities reported expenditure increases totaling \$21.8 billion, and 53 departments and activities reported expenditure decreases totaling \$1.5 billion. Significant reductions occurred in the Trade and Commerce Agency, Office of Emergency Services and the California Arts Council. Other departments' lower reported General Fund expenditures often resulted from shifts to other



funding sources. Therefore, while their General Fund expenditures decreased, their total expenditures may have remained the same or even increased.

Given that the greatest expenditure growth occurred in Local Assistance, not surprisingly, the greatest departmental expenditure growth occurred in departments that provide significant funding to local governments, local not-for-profits, etc. Specifically, we observed that \$15.2 billion of the total \$20.3 billion General Fund growth occurred in six budget areas, five of which provide significant Local Assistance. Exhibit 9, based on SCO Budgetary /Legal Basis Annual Report, shows these entities. Note that this SCO report summarizes expenditures by department, not by program.

Exhibit 9
Department/Reporting Entity Expenditure Growth According
to the SCO BLB Annual Reports
(dollars in thousands)

Department	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percentage Increase
Department of Education	\$22,297,963	\$26,438,638	\$4,140,675	18.6%
Tax Relief/Local Govt. Assistance	450,213	4,446,940	3,996,727	887.7%
Department of Health Services	8,029,428	11,197,109	3,167,681	39.5%
Department of Social Services	6,334,497	8,146,804	1,812,307	28.6%
Department of Dev. Services	672,285	1,879,679	1,207,394	179.6%
Department of Corrections	<u>4,283,111</u>	<u>5,188,903</u>	<u>905,792</u>	21.1%
Subtotal	\$42,067,497	\$57,298,073	\$15,230,576	36.2%
Other Departments	<u>15,204,386</u>	<u>20,266,204</u>	<u>5,061,818</u>	33.3%
Total	<u>\$57,271,883</u>	<u>\$77,564,277</u>	<u>\$20,292,394</u>	<u>35.4%</u>

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports FYs 1998–1999 and 2002–2003

In order to get programmatic expenditure detail and “drill down” into these growth areas, we first reviewed the Governor's Budget department detail. We noticed that department expenditures reported in the Governor's Budget (past year actual) did not agree with department expenditures as reported by SCO. Exhibit 10 illustrates the top six growth areas according to the Governor's Budget.

Exhibit 10
Department Expenditure Growth According to the Governor's Budget
(dollars in thousands)

Department	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percentage Increase
Department of Education	\$22,323,892	\$26,855,853	\$4,531,961	20.3%
Tax Relief/Local Govt. Assistance	931,845	4,446,748	3,514,903	377.2%
Department of Health Services	8,034,356	11,232,354	3,197,998	39.8%
Department of Social Services	6,334,504	8,149,818	1,815,314	28.7%
Department of Corrections	3,989,540	5,191,604	1,202,064	30.1%
Department of Dev. Services	<u>713,624</u>	<u>1,875,359</u>	<u>1,161,735</u>	162.8%
Subtotal	\$42,327,761	\$57,751,736	\$15,423,975	36.4%
Other Departments	<u>15,499,314</u>	<u>19,730,399</u>	<u>4,231,085</u>	27.3%
Total	<u>\$57,827,075</u>	<u>\$77,482,135</u>	<u>\$19,655,060</u>	<u>\$34.0%</u>

Source: Governor's Budget Summary, Schedule 9, FYs 2000–2001 and 2004–2005.

Expenditures reported in the Governor's Budget Summary are based on Schedule 10s submitted by the departments (discussed in the Budget Process Overview above).

Expenditures reported by SCO are based on department expenditures processed by SCO and accrual information from the Departments' financial statements. Although the top six growth areas remain the same (except the rank order of the Departments of Corrections and Developmental Services), the total difference between the two sources for the "top six" is \$193.4 million as illustrated in Exhibit 11.



Exhibit 11
Expenditure Differences
(dollars in thousands)

Department/Function	Increase SCO	Increase Gov. Budget	Difference
Department of Education	\$4,140,675	\$4,531,961	-\$391,286
Tax Relief/Local Govt. Assistance	3,996,727	3,514,903	481,824
Department of Health Services	3,167,681	3,197,998	-30,317
Department of Social Services	1,812,307	1,815,314	-3,007
Department of Dev. Services	1,207,394	1,161,735	45,659
Department of Corrections	<u>905,792</u>	<u>1,202,064</u>	<u>-296,272</u>
Subtotal	\$15,230,576	\$15,423,975	-\$193,399
Other Departments	<u>5,061,818</u>	<u>4,231,085</u>	<u>830,733</u>
Total	<u>\$20,292,394</u>	<u>\$19,655,060</u>	<u>\$637,334</u>

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports FYs 1998–1999 and 2002–2003

Governor's Budget Summary, Schedule 9 FYs 2000–2001 and 2004–2005

The variances are generally timing differences in reporting and differences in how expenditures are treated between a budget perspective and an accounting perspective. DOF annually reconciles the differences between the Governor's Budget and SCO; both sides make corrections and adjustments. Any differences that remain are reflected in the Governor's Budget Summary, Schedule 7, which annually reconciles the Governor's Budget to SCO versions of the General Fund. Therefore, differences between the two presentations are annually analyzed and disclosed. The annual cumulative differences between the Governor's Budget and SCO for the period FYs 1998–1999 through 2002–2003 are immaterial (less than 1 percent) in relation to total expenditures as illustrated in Exhibit 12.

Exhibit 12
Annual Expenditures Differences
(dollars in thousands)

Fiscal Year	Expenditures SCO	Expenditures Gov. Budget	Difference
1998–99	\$57,271,883	\$57,827,075	-\$555,192
1999–00	66,103,712	66,494,042	-390,330
2000–01	78,127,372	78,052,949	74,423
2001–02	76,551,184	76,751,710	-200,526
2002–03	77,564,277	77,482,135	82,142

Source: State Controller's Office, Budgetary/Legal Basis Annual Reports FYs 1998–1999 through 2002–2003.

Governor's Budget Summary, Schedule 9 FYs 2000–2001 through 2004–2005.

Department Expenditure Growth

The following is our analysis of the top six areas of General Fund growth. Since it focuses on specific program growth, we based our analysis on Governor's Budget data. As discussed above, although there are differences between the expenditures reported by SCO and the Governor's Budget, the top six areas remain the same regardless of source material.

Department of Education

The Department of Education incurred the largest General Fund expenditure growth increasing \$4.5 billion from \$22.3 billion in FY 1998–1999 to \$26.8 billion in FY 2002–2003. The Proposition 98 guarantee funding largely controls Education's funding and is the primary reason for the increase. Specifically, Proposition 98 Local Assistance funding increased \$3.8 billion from \$22 billion in FY 1998–1999 to \$25.8 billion in FY 2002–2003. In addition, non-Proposition 98 Local Assistance funding increased by \$648 million, from \$246 million in FY 1998–1999 to \$894 million in FY 2002–2003.

Tax Relief/Local Government Assistance

Tax Relief/Local Government Assistance is the second largest General Fund growth area, contributing \$3.5 billion to the total \$19.7 billion expenditure growth (Governor's Budget). The tax relief funding supplements several programs ranging from senior citizen renters' tax assistance to open space subventions. However, the Vehicle License Fee (VLF) Offset program is the largest portion of the increase representing \$3.3 billion of the \$3.5 billion growth. Furthermore, all Tax Relief/Local Government Assistance expenditures represent funding provided to local governments.

Department of Health Services

The Department of Health Services (DHS) represents the third highest General Fund expenditure growth area, contributing \$3.2 billion to the total \$19.7 billion growth (Governor's Budget). Notably, nearly all of the increase is attributable to increased Local Assistance funding as illustrated by Exhibit 13.

Exhibit 13
DHS General Fund Expenditures by Character
(dollars in thousands)

Character	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percent Increase
State Operations	\$201,611	\$256,731	\$55,120	27.3%
Local Assistance	<u>7,832,745</u>	<u>10,975,623</u>	<u>3,142,878</u>	40.1%
Total	<u>\$8,034,356</u>	<u>\$11,232,354</u>	<u>\$3,197,998</u>	<u>39.8%</u>

Source: Governor's Budget Summary, Schedule 9 FYs 2000–2001 and 2004–2005.



The predominant growth in Local Assistance is attributable to the California Medical Assistance Program (Medi-Cal), which provides health care services to welfare recipients and other qualified low-income persons (primarily families with children and the aged, blind or disabled). Specifically, Medi-Cal represents \$3.1 billion of the \$3.2 billion growth in DHS.

Approximately 94 percent of local assistance Medi-Cal funding goes directly to pay for benefits; the remaining 6 percent is for administration. Expenditures for Medi-Cal benefits are shared nearly equally by the General Fund and federal funds. In addition, the state offers 34 optional services, such as outpatient drugs and adult dental care, for which the federal government also provides matching funds.

DHS administers a broad range of public health programs and Medi-Cal services through two primary programs: Public and Environmental Health; and Health Care Services. As illustrated in Exhibit 14, nearly all of DHS' expenditure increase occurred in the Health Care Services Program. Over 97 percent of the Health Care Services Program's expenditures are for Medi-Cal services.

Exhibit 14
DHS Program Expenditure Growth
(dollars in thousands)

	1998–99	2002–03	Dollar Inc./Decr.	Percentage Inc./Decr.
Public and Environmental Health	\$230,504	\$271,439	\$40,935	17.8%
Health Care Services	7,797,065	10,962,392	3,165,327	40.6%
Other	<u>6,787</u>	<u>-1,477</u>	<u>-8,264</u>	-121.8%
Total	<u>\$8,034,356</u>	<u>\$11,232,354</u>	<u>\$3,197,998</u>	<u>39.8%</u>

Source: Governor's Budget FYs 2000–2001 and 2004–2005.

Most of the increases in Medi-Cal funding can be attributed to caseload increases resulting from Medi-Cal eligibility expansion for the aged, disabled, working parents and children. Average monthly Medi-Cal eligible caseload estimates indicate that caseload grew by 1.4 million, increasing from 5 million a month in FY 1998–1999 to over 6.4 million a month in FY 2002–2003. In addition, budgeted General Fund Medi-Cal pharmacy expenditures nearly doubled in growth, increasing from slightly under \$0.8 billion to slightly over \$1.4 billion for this same time period.

Department of Social Services

The Department of Social Services (DSS) is the fourth highest General Fund expenditure growth area, contributing \$1.8 billion to the total \$19.7 billion growth (Governor's Budget).

Moreover, the increase is entirely attributable to increased Local Assistance funding as illustrated by Exhibit 15.

Exhibit 15
DSS General Fund Expenditures by Character
(dollars in thousands)

Character	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Dec.	Percent Inc./Dec
State Operations	\$108,135	\$94,780	–\$13,355	–12.4%
Local Assistance	<u>6,226,369</u>	<u>8,055,038</u>	<u>1,828,669</u>	29.4%
<u>Totals</u>	<u>\$6,334,504</u>	<u>\$8,149,818</u>	<u>\$1,815,314</u>	<u>28.7%</u>

Source: Governor’s Budget Summary, Schedule 9, FYs 2000–2001 and 2004–2005.

DSS administers three primary programs: Welfare, Social Services and Licensing and the Disability Evaluations and Other Services Program. Exhibit 16 illustrates these programs’ expenditure growth.

Exhibit 16
DSS Program Expenditure Growth
(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Dec.	Percent Inc./Dec.
Welfare	\$5,211,677	\$6,276,295	\$1,064,618	20.4%
Social Services and Licensing	1,109,839	1,860,017	750,178	67.6%
Disability Evaluation and Other Services	10,534	13,506	2,972	28.2%
Other	<u>2,454</u>	<u>0</u>	<u>–2,454</u>	–100.0%
<u>Total</u>	<u>\$6,334,504</u>	<u>\$8,149,818</u>	<u>\$1,815,314</u>	<u>28.7%</u>

Source: Governor’s Budget, FYs : 2000–2001 and 2004–2005.

The Welfare Program provides temporary financial assistance to eligible California residents. The Social Services and Licensing Program monitors and oversees the development of policy, regulations and procedures for the delivery of services to clients, and the monitoring and evaluation of services delivered. As illustrated in Exhibit 17, the most significant growth occurred in five program elements in the Welfare and the Social Services and Licensing Programs, accounting for 95.8 percent of DSS’ General Fund expenditure growth.



Exhibit 17
DSS Program Expenditure Growth
(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percent Increase
Welfare Program				
<i>Supplemental Security</i>	\$2,243,056	\$3,005,490	\$762,434	34.0%
<i>Foster Care</i>	384,640	518,925	134,285	34.9%
<i>Adoption Assistance</i>	76,241	196,517	120,276	157.8%
Social Services and Licensing Program				
<i>In-Home Support Services</i>	530,329	1,091,324	560,995	105.8%
<i>Children Services</i>	497,524	658,466	160,942	32.4%
Other Programs	<u>2,602,714</u>	<u>2,679,096</u>	<u>76,382</u>	2.9%
Total	<u>\$6,334,504</u>	<u>\$8,149,818</u>	<u>\$1,815,314</u>	<u>28.7%</u>

Source: Governor's Budget, FYs 2000–2001 and 2004–2005.

Supplemental Security Income/State Supplementary Payment, a cash assistance program for low-income aged, blind and disabled persons, increased \$762.4 million (34 percent) from FYs 1998–1999 to 2002–2003. The increase is due primarily to the provision of statutory cost-of-living adjustments (COLA). Caseload grew by only 11 percent during the same time period.

The Foster Care Program provides cash payments for out-of-home care for children who have been removed from their own families due to abuse or neglect. Foster Care General Fund expenditures increased \$134.3 million (34.9 percent) from FYs 1998–1999 to 2002–2003, despite a 9 percent decline in program caseload. The growth was attributable to COLAs, rate increases for group homes and increased placements in higher-cost foster family agency and group homes.

The Adoption Assistance Program provides ongoing subsidies to encourage and promote the placement of children into adoptive homes. Program expenditures increased \$120.3 million (157.8 percent) from FYs 1998–1999 to 2002–2003. The increase is largely attributable to caseload increases averaging 16.3 percent annually, and coincided with the recently concluded Adoptions Initiative, which provided additional funding for adoption workers and resulted in increased finalized adoptions.

In-Home Supportive Services (IHSS) enables individuals to remain safely in their homes as an alternative to out-of-home care under the Personal Care Services Program and the Residual

Program. IHSS' General Fund expenditures increased \$561 million (105.8 percent) from FYs 1998–1999 to 2002–2003. According to DSS staff, program growth was due primarily to caseload growth, increases in authorized service hours and increases in the county wages and benefits.

Children's Services administers the Child Welfare System. Children's Services' General Fund expenditures increased \$160.9 million (32.4 percent) from FYs 1998–1999 to 2002–2003. DSS claims that program growth was due to caseload increases, particularly in the area of emergency response assessment, which experienced a 45 percent increase for the above-mentioned time period.

Department of Corrections

The California Department of Corrections (CDC) is the fifth highest General Fund expenditure growth area, contributing \$1.2 billion to the total \$19.7 billion growth (Governor's Budget).

As illustrated in Exhibit 18, the entire \$1.2 billion increase in general fund expenditures occurred for State Operations.

Exhibit 18
CDC General Fund Expenditures by Character
(dollars in thousands)

Character	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Decr.	Percent Inc./Decr.
State Operations	\$3,870,628	\$5,126,785	\$1,256,157	32.5%
Local Assistance	95,436	56,463	–38,973	–40.8%
Capital Outlay	<u>23,476</u>	<u>8,356</u>	<u>–15,120</u>	–64.4%
Totals	<u>\$3,989,540</u>	<u>\$5,191,604</u>	<u>\$1,202,064</u>	<u>30.1%</u>

Source: Governor's Budget and Governor's Budget Summary, Schedule 9, FYs 2000–2001 and 2004–2005.

CDC is organized into three main programs: Institutions, Health Care Services and Community Correctional Programs. As illustrated in Exhibit 19, the Institutions (\$879.8 million) and Health Care Programs (\$365.9 million) account for the entire \$1.2 billion increase from FYs 1998–1999 to 2002–2003.



Exhibit 19
CDC Program Growth
(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Decr.	Percent Inc./Decr.
Institutions	\$2,959,842	\$3,839,638	\$879,796	29.7%
Health Care Services	512,017	877,885	365,868	71.5%
Community Correctional	488,494	465,724	–22,770	– 4.7%
State Mandates	5,711	1	–5,710	–100.00%
Capital Outlay	<u>23,476</u>	<u>8,356</u>	<u>–15,120</u>	–64.4%
Totals	<u>\$3,989,540</u>	<u>\$5,191,604</u>	<u>\$ 1,202,064</u>	<u>30.1%</u>

Source: Governor's Budget, FYs 2000–2001 and 2004–2005.

Note: CDC's Administrative Costs are included in the specific program costs.

The Institutions Program has the ultimate responsibility of safely housing inmates committed to state prison as prescribed by law. The department oversees 32 institutions, divided into 3 regions, with an inmate population of approximately 160,000. The Health Care Services Program is responsible for managing and delivering health care statewide consistent with adopted standards for quality and scope of services within a custodial environment. The Community Services Program is responsible for protecting the public and assisting approximately 115,000 parolees in their reintegration to society.

As illustrated in Exhibit 20, CDC shows increased expenditures in the following five areas comprising 85.9 percent of the growth from FYs 1998–1999 to 2002–2003.

Exhibit 20
Highest Five Expenditure Area Increases by Object
(dollars in thousands)

Object	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percent Increase
Salaries and Wages	\$1,874,772	\$2,347,163	\$472,391	25.2%
Consultants/Professional Services	297,220	503,285	206,065	69.3%
Retirement	186,828	345,874	159,046	85.1%
Other Items of Expense	333,259	442,171	108,912	32.7%
Overtime	<u>157,565</u>	<u>244,270</u>	<u>86,705</u>	55.0%
Total—Top 5 Objects	<u>\$2,849,644</u>	<u>\$3,882,763</u>	<u>\$1,033,119</u>	36.3%
Percentage of Total	<u>71.4%</u>	<u>74.8%</u>	<u>85.9%</u>	
Totals—CDC	<u>\$3,989,540</u>	<u>\$5,191,604</u>	<u>\$1,202,064</u>	<u>30.1%</u>

Source: California Department of Corrections

See Appendix III, A Departmental Case Study: California Department of Corrections Increase in General Fund Expenditures from FYs 1998–1999 to 2002–2003, for a detailed analysis and discussion of the expenditure growth in these five areas.

Department of Developmental Services

The Department of Developmental Services (DDS) is the sixth highest growth area of General Fund expenditures, contributing \$1.2 billion to the total \$19.7 billion growth (Governor’s Budget).

Exhibit 21 illustrates the increases in State Operations and Local Assistance expenditures for the period from FYs 1998–1999 through 2002–2003. As illustrated, the more significant dollar growth occurred in Local Assistance (the Regional Centers). Note that much of the growth in State Operations reflects a change in funding mechanism for the Developmental Centers and is not actual expenditure growth.

Exhibit 21
Expenditure Growth by Character
(dollars in thousands)

	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Decr.	Percentage Inc./Decr.
State Operations	\$58,515	\$363,558	\$305,043	521.3%
Local Assistance	647,865	1,510,633	862,768	133.2%
Capital Outlay	<u>7,244</u>	<u>1,168</u>	<u>–6,076</u>	–83.9%
Total	<u>\$713,624</u>	<u>\$1,875,359</u>	<u>\$1,161,735</u>	<u>162.8%</u>

Source: Governor’s Budget Summary, FYs 2000–01 and 2004–05

Note: FY 1998–99 State Operations excludes \$214 million in GF expenditures for Medi-Cal related costs at the Developmental Centers funded through an interagency agreement with DHS.

DDS is responsible for ensuring that persons with developmental disabilities receive the services and support necessary to lead more independent, productive and normal lives and to make choices and decisions about their own lives. These services are provided primarily through the Community Services and the Developmental Centers Programs.

Exhibit 22 illustrates that the largest expenditure growth occurred in the Community Services Program where expenditures grew \$861.9 million (130.6 percent). The remaining expenditure growth, \$306.3 million, occurred in the Developmental Centers Program. However, \$214 million of this amount was not an actual increase in expenditures, but rather the result of a mechanical accounting change in the Developmental Centers Program funding. Prior to FY 2001–02, the Developmental Centers Program used General Funds only for services for non-Medi-Cal eligible residents. The remainder was funded by DHS General Fund budget and



transferred to DDS through an interagency agreement and reported as a reimbursement. Beginning in FY 2001–02, the funding for Medi-Cal eligible residents was directly funded through DDS and was reported as an expenditure, which resulted in the large increase.

Exhibit 22
DDS Program Expenditure Growth
(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Dec.	Percent Inc./Dec
Community Services	\$659,835	\$1,521,718	\$861,883	130.6%
Developmental Centers	46,133	352,470	306,337	664.0%
State Mandated Local Program	412	3	–409	–99.3%
Capital Outlay	<u>7,244</u>	<u>1,168</u>	<u>–6,076</u>	–83.9%
Total	<u>\$713,624</u>	<u>\$1,875,359</u>	<u>\$1,161,735</u>	<u>162.8%</u>

Source: Governor's Budget, FYs 2000–01 and 2004–05

Note: FY 1998–99 Developmental Centers excludes \$214 million in GF expenditures for Medi-Cal related expenditures at the Developmental Centers funded through an interagency agreement with DHS.

The Community Services Program provides community-based services to clients through 21 not-for-profit corporations known as Regional Centers. The Regional Centers' budget includes two major expenditure categories: purchase of services (POS) and operations. POS includes transportation, day programs and residential care. Regional Center operations include eligibility determinations and client assessments, development of individual program plans for clients and service coordination (case management), as well as administrative and personnel costs.

The Developmental Centers program operates five developmental centers and two smaller facilities. The developmental centers are licensed and certified state facilities. More than 7,800 employees staff the developmental centers and provide 24-hour, direct care to approximately 3,500 center clients with developmental disabilities.

DDS' largest expenditure growth was in the Community Services Program, reflecting increased caseloads and POS costs at the Regional Centers. Between FYs 1998–99 and 2002–03, the Regional Center caseloads grew by an average of 5 percent per year, a total increase of more than 40,000 clients. POS provided to these individuals increased more dramatically during this time period, increasing on average by 72 percent.

According to LAO, increases in caseload growth can be attributed to improved medical care and technologies (resulting in increased life expectancies for the developmentally disabled)

and increased cases of autism. Between FYs 1998–99 and 2002–03, caseloads of individuals professionally diagnosed with full syndrome autism increased by 97 percent. Factors related to increased POS include more intensive and costly services associated with an aging client population, and the comparatively higher costs associated with treating autism. In addition, federal requirements for quality of care and staffing resulted in some increased spending at community care facilities.

After adjusting for the Medi-Cal funding change, the remaining Developmental Center Program expenditure growth, \$106 million, is related to increases in staffing and a new treatment facility. During the four year period, 1,600 positions were added system-wide to the Developmental Centers in order to regain federal certification and federal funding. Funding increases resulted from the establishment of a Secure Treatment Facility (STF) at the Porterville Developmental Center and increased costs in serving non-Medi-Cal eligible residents residing in the STF.

General Fund Deficiencies

The state's fiscal control system does not allow departments to exceed their spending authority. With few exceptions (such as payroll), SCO will not process an expenditure claim unless specific spending authority and funding exist to pay the claim. Therefore, when departments anticipate current year expenditures will exceed their current year spending authority, they must request deficiency appropriations.

Departments first perform an internal review and identify measures to cut spending and postpone expenditures in order to minimize the potential deficiency. Once all internal measures are exhausted, departments submit deficiency request to DOF for the desired supplemental funding.

DOF reviews the requests and seeks additional savings, reductions and other options in order to minimize the deficiency and may approve, deny or modify the request. Once all requests have been considered, DOF proposes an annual Omnibus Bill that generally consolidates all deficiency requests. Apart from the Omnibus Bill, DOF as well as individual departments may introduce separate deficiency legislation. Deficiency bills are further reviewed, scrutinized and modified by the Legislature before supplemental funding is approved.

Exhibit 23 illustrates identified General Fund deficiency funding as a percentage of total General Fund expenditures. Although deficiencies significantly increased in FY 2002–03 as a result of Medi-Cal caseload adjustments, deficiencies have not increased significantly in relation to total expenditures. As illustrated, deficiencies are not a significant percentage of total expenditures and generally fluctuate between 0.5 and 1.7 percent of expenditures. Moreover, these percentages are consistent with those from FYs 1980–81 to 1997–98, which ranged from a low of 0.34 percent in FY 1997–1998 to a high of 1.75 percent in FY 1986–87.



Exhibit 23
Deficiencies
(dollars in millions)

Fiscal Year	Deficiencies	Expenditures	Deficiencies as a Percentage of GF Expenditures
1998–99	\$937	\$57,827	1.6%
1999–00	730	66,494	1.1%
2000–01	386	78,053	0.5%
2001–02	596	76,752	0.8%
2002–03	1,304	77,482	1.7%

Source: Governor's Budget, FYs 2000–01 through 2004–05

Chapter 43, Statutes of 2003, appropriated \$727 million to DHS for unanticipated Medi-Cal costs.

Chapter 2, Statutes of 1999, provided CDF with \$63.2 million for fire prevention and suppression.

Although the doubling of deficiencies from FY 2001–2002 to 2002–2003 contributed to the state's operating deficits, deficiencies did not cause them. Moreover, deficiency funding for FYs 1998–1999 through 2002–2003 is not inconsistent with past deficiency funding percentages.

While overall percentages have remained relatively stable, four departments have had reoccurring deficiencies in recent years and account for the bulk of the deficiencies reported. As Exhibit 24 illustrates, DHS, CDC, DDS and the Department of Forestry and Fire Protection have consistently received deficiency funding.

Exhibit 24
Departmental Deficiencies
(dollars in thousands)

Department	1998–99	1999–00	2000–01	2001–02	2002–03
Health Services	\$604,090	\$467,355	\$10,503	\$155,496	\$727,225
Corrections	139,586	20,709	200,218	257,109	265,298
Developmental Services	53,124	82,174	27,390	16,351	88,837
Forestry & Fire Protection	10,052	88,440	49,000	95,000	8,389
Other	<u>130,582</u>	<u>71,249</u>	<u>98,597</u>	<u>71,505</u>	<u>214,479</u>
Total	<u>\$937,434</u>	<u>\$729,927</u>	<u>\$385,708</u>	<u>\$595,461</u>	<u>\$1,304,228</u>

Source: Governor's Budget FYs 2000–01 through 2004–05

Chapter 43, Statutes of 2003, appropriated \$727 million to DHS for unanticipated Medi-Cal costs.

Chapter 2, Statutes of 1999, provided CDF with \$63.2 million for fire prevention and suppression.

Department of Health Services

DHS deficiency funding between FYs 1998–1999 and 2002–2003 ranged from a low of \$10.5 million in FY 2000–2001 to a high of \$727.2 million in FY 2002–2003. Exhibit 25 illustrates DHS’s General Fund deficiency funding as a percentage of its total General Fund expenditures. For the five-year period, 4.1 percent of DHS’s General Fund expenditures were augmented through a deficiency funding.

Exhibit 25
DHS Deficiencies
(dollars in thousands)

Fiscal Year	Deficiency Funding	Total GF Expenditures	Deficiencies as a Percentage of GF Expenditures
1998–99	\$604,090	\$8,034,359	7.5%
1999–00	467,355	8,664,874	5.4%
2000–01	10,503	9,903,047	0.1%
2001–02	155,496	10,418,634	1.5%
2002–03	<u>727,225</u>	<u>11,232,353</u>	6.5%
Total	<u>\$1,964,669</u>	<u>\$48,253,267</u>	<u>4.1%</u>

Source: Governor’s Budget, 2000–01 through 2004–05

Medi-Cal funding represents \$1.94 billion of the total \$1.96 billion in deficiency funding between FYs 1998–1999 and 2002–2003. As illustrated in Exhibit 26, nearly half of the Medi-Cal program deficiencies were due to unanticipated increases in either rates or the number of eligible Medi-Cal beneficiaries. An additional \$607.8 million is the result of unrealized Legislative or Administrative assumptions, and \$141.9 million resulted from delayed savings. Finally, the remaining \$255.8 million is due to other reasons, including lawsuits.

Exhibit 26
Medi-Cal Deficiencies
(dollars in thousands)

Description	1998–99	1999–00	2000–01	2001–02	2002–03	Total
Increases in Rates and Number Eligible	\$347,700	\$184,800	\$8,705	\$72,500	\$319,900	\$933,605
Unrealized Legislative or Admin. Assumptions	196,200	239,000	0	48,500	124,100	607,800
Savings Delayed Due To Late Budget					141,900	141,900
Other	<u>60,190</u>	<u>31,268</u>	<u>0</u>	<u>22,994</u>	<u>141,325</u>	<u>255,777</u>
Total	<u>\$604,090</u>	<u>\$455,068</u>	<u>\$8,705</u>	<u>\$143,994</u>	<u>\$727,225</u>	<u>\$1,939,082</u>

Source: State of California Department of Health Services



Department of Corrections

CDC deficiency funding between FYs 1998–1999 and 2002–2003 ranged from a low of \$20.7 million in FY 1999–2000 to a high of \$265.3 million in FY 2002–2003. Exhibit 27 illustrates CDC’s General Fund deficiency funding as a percentage of its total General Fund expenditures. For the five-year period, CDC’s General Fund expenditures were augmented by 3.9 percent through deficiency funding.

Exhibit 27
CDC Deficiencies
(dollars in thousands)

Fiscal Year	Deficiency Funding	Total GF Expenditures	Deficiencies as a Percentage of GF Expenditures
1998–99	\$139,586	\$3,989,540	3.5%
1999–00	20,709	4,189,828	0.5%
2000–01	200,218	4,584,935	4.4%
2001–02	257,109	4,998,327	5.1%
2002–03	<u>265,298</u>	<u>5,191,605</u>	5.1%
Totals	<u>\$882,920</u>	<u>\$22,954,235</u>	<u>3.9%</u>

Source: Governor’s Budget, FYs 2000–01 through 2004–05

Exhibit 28 provides detail for the CDC deficiencies. As illustrated, structural deficits, increased population, medical costs and workers' compensation costs represent the most significant areas.

Exhibit 28
CDC Deficiency Summary
(dollars in thousands)

Description	1998-99	1999-00	2000-01	2001-02	2002-03	Total
Structural budgetary shortfall	\$70,807	\$0	\$52,500	\$70,774	\$69,364	\$263,445
Inmate population increases	0	0	28,635	7,701	126,549	162,885
Medical Contracts, drugs and psych supplies	0	778	45,501	80,133	0	126,412
Workers' Compensation increases	0	0	27,064	42,695	32,820	102,579
Utility increases	0	0	29,118	17,979	12,867	59,964
Overtime exceeded budgeted allocation	0	0	0	29,580	21,092	50,672
Operational Costs - Bargaining Unit 6	31,126	0	1,672	2,277	2,362	37,437
Local Assistance budgetary shortfall	33,197	0	0	0	0	33,197
Court Mandates	1,089	10,242	0	870	0	12,201
Cesar Chavez Holiday pay	0	0	6,898	0	0	6,898
Approved positions without approved funding	0	1,532	0	5,100	0	6,632
Emergency repair of San Quentin shoreline	0		5,600	0	0	5,600
Underbudgeted leave for posted positions	0	4,126	0	0	0	4,126
Medical guarding and transportation costs	0		3,230	0	0	3,230
Establish Psych. Services Unit @ CSP-SAC	1,110		0	0	0	1,110
Inmate medical services - women institutions	0	1,109	0	0	0	1,109
Other	<u>2,257</u>	<u>2,922</u>	<u>0</u>	<u>0</u>	<u>244</u>	<u>5,423</u>
Total	<u>\$139,586</u>	<u>\$20,709</u>	<u>\$200,218</u>	<u>\$257,109</u>	<u>\$265,298</u>	<u>\$882,920</u>

Sources: Governor's Budget FYs 2000-01 through 2004-05
California Department of Corrections



By definition, a structural budgetary shortfall occurs when total expected expenditures exceed total appropriated resources. In other words, the department is unable to live within its budgeted appropriation. Section 27 of the annual Budget Act allows adjustments when program costs exceed budget estimates, such as an increase in the program's caseload. Section 27 is intended to allow adjustments to spending amounts, consistent with the Legislature's policy objectives as reflected in the annual budget. Each year, the Legislature has approved CDC's Section 27 request to address its "structural budgetary shortfall."

CDC receives funding based on inmate population projections. Underestimating CDC's inmate population has contributed to budget deficits in FYs 2000–2001, 2001–2002 and 2002–2003. According to CDC, the Administration and Legislature know that reductions in inmate population are not going to materialize; yet departmental funding continues to be based on estimates of reduced inmate populations.

According to DOF, the simplistic explanation that the Administration and Legislature have not accurately budgeted population increases is not accurate. While CDC has incurred costs in excess of its budget authority, the deficiencies are related to other structural issues, such as backfilling posted positions with overtime when correctional officers are on leave, or to CDC policy changes, such as running a higher level of Administrative Segregation than was budgeted. CDC's situation is discussed further in Appendix III.

Department of Developmental Services

DDS's deficiency funding between FYs 1998–1999 and 2002–2003 ranged from a low of \$16.4 million in FY 2001–2002 to a high of \$88.8 million in FY 2002–2003. Exhibit 29 illustrates DDS's General Fund deficiency augmentations as a percentage of its total General Fund expenditures. For the five-year period, 4.2 percent of DDS's General Fund expenditures were augmented through a deficiency funding.

Exhibit 29
DDS Deficiencies
(dollars in thousands)

Fiscal Year	Deficiency Funding	Total GF Expenditures	Deficiencies as a Percentage of GF Expenditures
1998–99	\$53,124	\$706,380	7.5%
1999–00	82,174	910,746	9.0%
2000–01	27,390	1,127,094	2.4%
2001–02	16,351	1,717,747	1.0%
2002–03	<u>88,837</u>	<u>1,874,193</u>	4.7%
Total	<u>\$267,876</u>	<u>\$6,336,160</u>	4.2%

Source: Governor's Budget, FYs 2000–01 through 2004–05

Most of DDS's deficiency funding derived from the loss of federal funds. Specifically, at the Regional Centers, the loss resulted from decreases in federal reimbursements for the Home and Community Based Services Waiver and Temporary Assistance for Needy Families. At the Developmental Centers, the loss of federal funds resulted from the decertification or failure to meet recertification status at five facilities. While DDS received \$88.8 million in deficiency funding in 2002–2003, of which \$46.8 million was for increased POS and administration costs at the Regional Centers, DDS incurred a \$52 million unallocated budget reduction at budget enactment. DDS officials stated that since the Regional Centers are required by the Lanterman Act to provide consumer services and support, the unallocated budget reduction could not be fulfilled, which contributed to DDS's deficiency. Exhibit 30 provides a summary of DDS's deficiencies.

Exhibit 30
DDS Deficiency Summary
(dollars in thousands)

Description	1998–99	1999–00	2000–01	2001–02	2002–03	Total
Loss of federal funds for Regional Centers (reimbursement funds)	\$47,875	\$48,347	\$0	\$0	\$42,000	\$138,222
Loss of federal funds Developmental Centers (decertification)	4,887	33,827	26,838	16,351	0	81,903
Increase in POS Regional Centers	0	0	0	0	33,127	33,127
Increase in Regional Center Operation Costs	0	0	0	0	13,713	13,713
Other	<u>362</u>	<u>0</u>	<u>552</u>	<u>0</u>	<u>0</u>	<u>914</u>
Total	<u>\$53,124</u>	<u>\$82,174</u>	<u>\$27,390</u>	<u>\$16,351</u>	<u>\$88,840</u>	<u>\$267,879</u>

Source: State of California, Department of Developmental Services

Department of Forestry and Fire Prevention

CDF deficiency funding between FYs 1998–1999 and 2002–2003 ranged from a high of \$95 million in FY 2001–2002 to a low of \$8.4 million in FY 2002–2003. Exhibit 31 illustrates CDF's General Fund deficiency augmentations as a percentage of its total General Fund expenditures. For the five-year period, 11.2 percent of CDF's General Fund expenditures were augmented through deficiency funding.



Exhibit 31
CDF Deficiencies
(dollars in thousands)

Fiscal Year	Deficiency Funding	Total GF Expenditures	Deficiencies as a Percentage of GF Expenditures
1998–99	\$10,052	\$348,415	2.9%
1999–00	88,440	464,319	19.0%
2000–01	49,000	445,394	11.0%
2001–02	95,000	531,897	17.9%
2002–03	<u>8,389</u>	<u>450,334</u>	1.9%
Totals	<u>250,881</u>	<u>2,240,359</u>	11.2%

Source: Governor's Budget FYs 2000–01 through 2004–05

Exhibit 32 provides a summary description of CDF's deficiencies as described in the Governor's Budget, Section 9840, Augmentation for Contingencies or Emergencies. As illustrated, the majority of CDF's deficiencies relate to emergency fire activities.

Exhibit 32
CDF Deficiency Summary
(dollars in thousands)

Description	1998–99	1999–00	2000–01	2001–02	2002–03	Total
Fire Suppression and Protection	\$9,800	\$8,440	\$49,000	\$95,000	\$0	\$242,240
Other	<u>252</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>8,389</u>	<u>8,641</u>
Total	<u>\$10,052</u>	<u>\$88,440</u>	<u>\$49,000</u>	<u>\$95,000</u>	<u>\$8,389</u>	<u>\$250,881</u>

Source: Governor's Budget, FYs 2000–01 through 2004–05

Spending Authority vs. Actual Expenditures

Although state expenditures increased from FYs 1998–1999 through 2002–2003, the growth is consistent with increased appropriations, or spending authority. As previously noted, the state's fiscal control system does not allow departments to exceed their spending authority. Exhibit 33 illustrates that total General Fund expenditures have remained within the spending authority granted by the Legislature and the Administration.

Exhibit 33
Spending Authority vs. Expenditures
(dollars in thousands)

Fiscal Year	Spending Authority	Expenditures	Expenditures Under/(Over)
1998–99	\$58,081,366	\$57,271,883	\$809,483
1999–00	66,810,245	66,103,712	706,533
2000–01	79,321,994	78,127,373	1,194,621
2001–02	79,714,143	76,551,184	3,162,959
2002–03	79,388,592	77,564,277	1,824,315

Source: State Controller's Office, FYs 1998–99 through 2002–2003 Comprehensive Annual Financial Report

Even if we were to reduce expenditure authority by the amount of the deficiency augmentations, total expenditures would still be within budgeted amounts in three of the five years reviewed, as illustrated in Exhibit 34. FYs 1998–1999 and 1999–2000 (before the revenue collapse) are the only ones in which expenditures would have exceeded spending authority net of deficiency funding. Although we cannot assume that state spending would have remained the same without the deficiency funding augmentations, this comparison does provide a general illustration that deficiencies and deficiency funding did not significantly affect the state's fiscal condition in FYs 2001–2002 and 2002–2003.

Exhibit 34
Spending Authority vs. Actual Expenditures
(dollars in thousands)

Fiscal Year	Spending Authority	Less Approved Deficiencies	Net Spending Authority	Less Expenditures	Expenditures Under/(Over)
1998–99	\$58,081,366	937,434	\$57,143,932	\$57,271,883	–\$127,951
1999–00	66,810,245	729,927	66,080,318	66,103,712	–23,394
2000–01	79,321,994	385,708	78,936,286	78,127,373	808,913
2001–02	79,714,143	595,461	79,118,682	76,551,184	2,567,498
2002–03	79,388,592	1,304,228	78,084,364	77,564,277	520,087

Source: State Controller's Office, Comprehensive Annual Financial Report FYs 1998–99 through 2002–03
State Controller's Office, Budgetary/Legal Basis Annual Report, FYs 1998–99 through 2002–03
Governor's Budget FYs 2000–01 through 2004–05

The table shows that the problem is more likely one of spending authority exceeding revenue (without any reserves for flexibility) rather than spending in excess of appropriations. Since



departments do not control their own revenue streams, state spending must be controlled by limiting spending authority and authorizing spending at appropriate levels. Note that the annual expenditures in this exhibit are as reported by SCO. The same analysis using the annual expenditures reported in the Governor's Budget Summary, Schedule 9 would reflect similar results.

General Fund Encumbrances

In order to ensure adequate funding for purchasing goods or services ordered but not received at year-end, state departments encumber unused appropriated funds to meet their obligations in a subsequent fiscal year. The encumbrance process requires departments to determine that funding is available and that encumbrances are supported by valid documents, such as purchase orders or contracts. Encumbrances are commitments for expenditures; departments accrue valid encumbrances as expenditures at year-end and report them in their financial statements. The state's cumulative encumbrance balance is annually reported in the SCO Budgetary/Legal Basis Annual Report. Once an obligation has been paid, modified or canceled, any remaining funds are disencumbered, thus freeing up funds for other obligations.

As Exhibit 35 illustrates, encumbrances are not a significant portion of state expenditures; however, they did increase by \$1.1 billion from FY 1999–2000 to 2000–2001. This growth is not surprising given the overall increase in state appropriations and expenditures in FY 2000–2001. Although encumbrances more than doubled in FY 2000–2001, the state's encumbrance balance is slowly returning to a more traditional level which hovers around 1 percent of annual expenditures.

Exhibit 35
Encumbrances
(dollars in thousands)

Fiscal Year	Expenditures	Encumbrances	Encumbrance as Percentage of Expenditures
1998–99	\$57,271,883	\$591,947	1.0%
1999–00	66,103,712	701,275	1.0%
2000–01	78,127,372	1,834,257	2.3%
2001–02	76,551,184	1,491,504	1.9%
2002–03	<u>77,564,277</u>	<u>1,037,374</u>	1.3%
Total	<u>\$355,618,428</u>	<u>\$5,656,357</u>	1.6%

Source: State Controller's Office, Budgetary/Legal Basis Annual Report, FYs 1998–99 through 2002–03

In order to identify the departments with the most significant encumbrance growth in FY 2000–2001, we obtained reports from SCO that listed encumbrances by fiscal year and department. After identifying the departments with the greatest growth, we surveyed them in order to determine what caused the large increases. As illustrated in Appendix IV, the large increase is a result of the increased appropriations, particularly in Local Assistance and Capital Outlay projects. Capital Outlay projects frequently run multiple years, and their funding likewise carries over; therefore, the increased encumbrance balance is not unexpected.

Since the state’s encumbrance balance ballooned in FY 2000–2001, the balance has been steadily declining, but still remains high. Appendix V lists the departments with the largest balances as of June 30, 2003, and the monitoring, if any, related to the balances.

The following highlights the comments of 13 survey respondent departments regarding what controls exist for monitoring encumbrance balances:

- Six departments have not had a recent external or internal audit of their encumbrances.
- Five departments recently had their encumbrance policies and balances audited by an outside entity, such as OSAE or BSA.
- One department recently performed an internal audit of their encumbrances.
- One department is currently under review by OSAE to determine the validity and dollar amount of their outstanding encumbrances.

Twelve departments reported that they monitor their encumbrances internally, via periodic sharing and interpreting of CALSTARS reports between accounting/budgetary personnel and program personnel. The lone exception is the Office of Criminal Justice and Planning, which no longer exists as a separate entity; the Office of Emergency Services has assumed responsibility for its fiscal affairs.

Different Reporting Methods

Government Code Section 12460 requires SCO to report the state’s financial condition on Budgetary/Legal Basis (BLB) and on a Generally Accepted Accounting Principles (GAAP) basis. Specifically, Section 12460 states:

[An] annual report shall be prepared in the manner that will account for revenues and expenditures on the same basis as that of the Governor’s Budget and the Budget Act. The format of the budgetary legal report shall be prepared as closely as possible in accordance with Generally Accepted Accounting Principles.

The code section further states:

Until the Controller’s records, the Budget Act and information provided by each state department and agency based on the state’s accounting system will permit the



conversion to Generally Accepted Accounting Principles, the Controller shall issue an additional report prepared strictly in accordance with Generally Accepted Accounting Principles.

Exhibit 36 illustrates the state's FY 2002–2003 fiscal activity as reported in the Governor's Budget Summary (GBS) and by SCO on a BLB and GAAP basis. As indicated, differences exist among the three methods resulting in significant differences in fund balance.

Exhibit 36
Reporting Methods Variance FY 2002–2003
(dollars in thousands)

	GBS BLB	SCO BLB	SCO GAAP
Beginning Fund Balance	–\$1,474,172	–\$2,109,760	–\$4,452,885
Revenues	68,536,453	68,545,784	66,133,497
Economic Recovery Bonds	9,242,000	0	0
Transfers In	<u>2,785,113</u>	<u>3,289,521</u>	<u>3,721,512</u>
Subtotal	80,563,566	71,835,305	69,855,009
Expenditures	–77,482,135	–77,564,277	–76,571,568
Transfers Out	<u>0</u>	<u>–369,955</u>	<u>–2,714,350</u>
Subtotal	–77,482,135	–77,934,232	–79,285,918
Other Sources (Uses)	<u>0</u>	<u>672,452</u>	<u>515,996</u>
Ending Fund Balance	<u><u>\$1,607,259</u></u>	<u><u>–\$7,536,235</u></u>	<u><u>–\$13,367,798</u></u>

Source: Governor's Budget Summary, Schedule 1 and Schedule 8, FY 2004–05

State Controller's Office, Budgetary/Legal Basis Annual Report, FY 2002–03

State Controller's Office, Comprehensive Annual Financial Report FY 2002–03

The primary difference between the GBS and the SCO BLB is the recognition of \$9.2 billion in bond proceeds. Although the GBS accrues the bond proceeds and recognizes the bond proceeds as revenue in FY 2002–2003, SCO did not accrue or recognize the bond proceeds as revenue until the bonds were issued in FY 2003–2004.

The GBS reporting is based on a budgeting or planning perspective and, as with any plan, includes assumptions for differing fiscal scenarios. The Administration anticipated the bonds would be issued; therefore, the funding would be available and the spending plan was developed based on this anticipated revenue source. On the other hand, SCO did not record the revenue until the bonds were issued. Both are accurate given their different purposes and perspectives. Although the reported difference is significant in FY 2002–2003, the two presentations are usually consistent with each other. Moreover, GBS Schedule 7 annually

reconciles the ending GBS General Fund balance to the ending SCO General Fund balance; therefore, differences between the two presentations are annually resolved and disclosed.

As also illustrated, a significant difference also exists between the SCO BLB and the SCO GAAP basis. Exhibit 37 reconciles the differences between the presentations.

Exhibit 37
SCO BLB and GAAP Reconciliation
(dollars in thousands)

BLB Fund Balance		-\$7,536,236
Inter-fund Receivables	\$42,816	
Loans Receivable	109,227	
Inter-fund Payables	-2,109,630	
Loans Payable	-25,000	
Escheat Property	-816,900	
Other	-26,893	
Liabilities Budgeted in Subsequent Years	<u>-3,005,182</u>	
GAAP Fund Balance		<u><u>-\$13,367,798</u></u>

*Source: State Controller's Office, Comprehensive Annual Financial Report
FY 2002-03*

As illustrated, the inter-fund payables and liabilities budgeted in subsequent years are the significant areas contributing to the variance. Inter-fund payables are loans from other funds and are considered revenue on BLB; however, these loans are considered a liability under GAAP and reduce the fund balance accordingly.

The large Liabilities Budgeted In Subsequent Years balance is primarily a result of approximately \$2 billion in Education funding being deferred into FY 2003-2004. Since legislation was passed that deferred the payments, the BLB reporting correctly excluded the expense from the FY 2002-2003 statements. However, on a GAAP basis, the expense, or liability, is clearly identifiable and measurable and therefore, accrued as an expense.

GAAP represents an established and standardized set of principles that when followed allow for consistent and comparable reporting of financial information. Unlike current law that can be (and often is) changed in order to delay the recognition of expenses and liabilities, or accelerate the recognition of revenue, using a GAAP reporting basis minimizes opportunities for fiscal manipulation in order to influence fiscal reporting.



Furthermore, since Government Code 12460 identifies GAAP-basis reporting as the preferred method, we believe the state should consider moving towards implementing a statewide system that requires all financial data be reported on a GAAP basis.

Conclusion

Today, California state government faces an unprecedented financial crisis. The state's ending General Fund balance has decreased by \$11.4 billion, from \$3.9 billion at the end of FY 1998–1999 to a (negative) –\$7.5 billion at the end of FY 2002–2003. From FYs 1998–1999 to 2002–2003, General Fund expenditure increases have outpaced revenue increases by almost 3 to 1, as expenditures have increased by \$20.3 billion, while revenues increased by \$7.1 billion. This information is neither new, nor surprising to anyone who has paid attention to the state's worsening financial situation.

Six departments/functions account for approximately \$15 billion or 75 percent of the state's General Fund expenditure growth from FY 1998–1999 to FY 2002–2003. For five of the six areas, the growth essentially occurred in local assistance funding, which primarily provides funding for local governments.

Although the state's deficiency and encumbrance balances have increased in recent years, they are not significantly out of line with historical levels. Moreover, the state's annual expenditures are consistently within budgeted spending authority. Although state spending has increased, encumbrances, deficiencies and exceeding spending authorities did not cause the operating deficits of FYs 2001–2002 and 2002–2003.

The state's three primary mechanisms for reporting fiscal activity are: the Governor's Budget, the SCO's Budgetary/Legal Basis Annual Report and the SCO's Comprehensive Annual Financial Report. Although there are differences among these three documents, each is correct given its parameters and circumstances. The SCO maintains the official records of the state and reports the state's fiscal condition using two different bases of accounting as required by Government Code 12460. The Governor's Budget is a spending plan for the upcoming budget year that includes current year spending estimates and past year actual expenditures. A budget represents how expenditures are to be funded, not necessarily an accounting representation of the state's fiscal condition; moreover, with any budget plan there are assumptions and expectations that may or may not occur. Additionally, budgeting does not have to adhere to strict accounting rules in the treatment of revenues and expenditures, which allows for needed flexibility, but also allows for manipulation as well.

In March 2004, California voters approved Proposition 57, "The Economic Recovery Bond Act" to refinance California's accumulated debt, and Proposition 58 to amend the state Constitution to enact and maintain a balanced budget, establish a specific reserve requirement and restrict future deficit-related borrowing.

California's leaders have the authority and the means to make difficult program and service policy decisions which affect all Californians. Furthermore, they bear the responsibility to allocate the state's limited resources based on the applicable mission, objectives, goals or priorities for providing programs and services. Those decisions must address the continuing practice of appropriating more than might be collected. The rules, practices, and methodologies exist to control the budget. Does the state's leadership have the will to follow them?



Financial Review

California's Automated Financial Systems

California state government depends on its automated financial systems to record and report financial information. This information is critical for making sound decisions at every level of government.

This portion of the engagement includes a survey of California's automated financial systems and their corresponding internal controls. The objectives are to determine the following: controls are adequate to detect errors and prevent fraud or waste; financial information is timely, reliable and fairly stated; systems are economic and efficient; and the appropriate financial information is available to program managers and decision-makers.

The scope of this survey was to:

- Review the history and status of the state's financial systems and the related enterprise or strategic planning effort regarding these systems.
- Determine the critical attributes of existing financial systems.
- Identify and review financial system projects approved in the last four years to determine the scope of new projects and the state's direction.
- Review audits of financial systems to assess the scope and sufficiency of audit coverage.
- Interview state agencies that have implemented administrative and financial enterprise systems to identify lessons learned.
- Identify lessons learned from other public sector financial systems.

For purposes of this engagement, we have employed the federal Office of Management and Budget definition of "financial system," which they define as follows:

"... an information system, comprised of one or more applications that is used for any of the following:

- collecting, processing, maintaining, transmitting and reporting data about financial events;
- supporting financial planning or budgeting activities;
- accumulating and reporting cost information; or
- supporting the preparation of financial statements.

... A financial system encompasses automated and manual processes, procedures, controls, data, hardware, software and support personnel dedicated to the operation and maintenance of system functions."

Internal Control for State Agencies

Significant attention has been directed toward internal control to provide confidence and improve operations because organizations are susceptible to fraud, waste and abuse. Further, because financial systems represent a key component to the reliability of financial reporting they must be considered in the internal control structure.

The Financial Integrity and State Manager's Accountability Act (FISMA) of 1983, Government Code (GC) Sections 13400–13407, was enacted to set responsibility for control at the highest levels. Moreover, FISMA is designed to help ensure that adequate internal controls are in place to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency and encourage adherence to policies.

In September 1992, the Committee of Sponsoring Organizations of the Treadway Commission's report titled *The Internal Control-Integrated Framework* (COSO Report) expanded the definition of internal control as a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following three categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.

More recently, in response to private sector frauds and failures, Congress passed the Sarbanes-Oxley Act of 2002 to reflect the public's expectations of an organization's due diligence regarding financial management and reporting. The Sarbanes-Oxley Act was written to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes. It requires management to establish and maintain an effective and adequate internal control structure, and its requirements are relevant to state government as well.

History of California's Automated Financial Systems

There are approximately 200 California state agencies, each operating within a financial framework established by law and policy. Each is permitted independence to tailor operations to meet the organization's needs. A brief explanation of the evolution of California's existing financial systems is provided to help understand the history and the environment today.

The need for a uniform system of accounting in California was first recognized in 1911, when the Legislature established the Department of Public Accounting. In 1921 and 1965, the duties of devising and installing a uniform system of accounting and reporting were transferred to the Department of Finance (DOF) and the Department of General Services, respectively. In 1973, the duties were transferred back to DOF, where they remain today.

GC Section 13300 mandates DOF to devise, install and supervise a modern and complete accounting system for each state agency permitted or charged by law with handling public



money. AB 3322 (Chapter 1284, Statutes of 1978) modified and reaffirmed this mandate, and required, among other things, a coding system to obtain accurate and comparable records, reports, and statements of all the state's financial affairs. The California Fiscal Information System (CFIS) project resulted from this legislation. The CFIS project included:

- The Financial Information System—the CFIS database
- The California State Accounting & Reporting System (CALSTARS)
- Uniform Codes Manual (UCM)
- Governor's Budget and Budget Act formats
- SCO Fund Accounting and Disbursement System
- Data exchange with State Treasurer Office (STO) Warrant Redemption and Deposit Reconciliation System
- Legislative and Executive Branch access to the basic system data
- Budget Preparation System (BPS)
- Change Book System
- Legislative Information System (LIS)
- Performance Measures

The CFIS project components were completed by the early 1980s and many are still active; but, the CFIS database requirements were suspended in 1985. The major concerns with the central database included issues with data (preparation, level of detail, timeliness and accuracy), knowledge, training, skills and access (terminals). Most other components of the original CFIS project remain in place and in use and have had some level of update or improvement over the years.

The state's core accounting system, CALSTARS, was implemented July 1, 1981. The authorizing legislation exempted eight departments (Department of Transportation, Department of Motor Vehicles, Employment Development Department, Department of Rehabilitation, Department of Water Resources, Department of Education, Department of Health Services and Department of Social Services), because they already had automated systems in place. Today, 31 state agencies (including the Legislature, Judicial and the Universities) are exempt from using CALSTARS. Exemptions to CALSTARS are determined on a case by case basis; there are no specific criteria for exemption. In 2003, CALSTARS was used by 90 state accounting offices for the accounting of 178 agencies.

While CALSTARS provides for statewide uniformity and also allows individual agency specificity through a series of unique tables and transaction codes, some functions and departmental business needs are not addressed. Examples include cashiering, large volume accounts receivable, large volume disbursement detail, billing, purchasing, inventory/fixed assets, budget preparation, management decision-making/analysis and federal requirements. The system is not a relational database with integrated data; it lacks real-time processing or a graphical user interface.

As the state has become more complex and automation demands have increased, departments are exploring enterprise systems, also known as Enterprise Resource Planning (ERP) systems: integrated software tools that allow for an exchange of information using a common or centralized database. Plans and proposals for ERP systems have been in development for the past several years.

In July 1997, the Department of Information Technology (DOIT) created the Enterprise Systems Subcommittee of the Information Technology Coordinating Council (ITCC) (hereafter called the Subcommittee) to help the state develop a comprehensive strategy for managing the development of information technology systems that produce and use data vital to the state's administrative operations (i.e., enterprise systems). The enterprise administrative systems being proposed included: Financial-Accounting, Human Resources, Procurement/Ordering, Asset Management and Inventory Management-Facilities Management. The Subcommittee's observations and recommendations included encouraging collaboration and information-sharing among departments, encompassing existing and planned projects in an Enterprise Systems Strategy and implementing two or three pilot enterprise systems (including an interagency consortium). The Subcommittee also recommended a moratorium until some pilots were evaluated and a standing committee of central (control) agencies to coordinate their data requirements in order to reduce unnecessary cost and redundant purchases.

However, the Subcommittee chair expressed concerns that, "...[A]bsent a very strong and involved central authority, large central administrative (enterprise) systems fail because of their very scale and the competing views of their participants."

The three pilots recommended by the Subcommittee were the Health and Human Services Data Center, the Department of General Services and the Department of Transportation. A consortium with three or more members was also recommended and several departments expressed a willingness to consider participating.

The pilot projects and other enterprise projects were approved but the consortium approach was not clearly defined and was not implemented. The ITCC did not track or follow up on the pilot projects or other departments that implemented enterprise systems or portions of enterprise systems. The ITCC legislation sunset in 2002 along with the DOIT enabling legislation. Currently, no statewide administrative systems enterprise plan or strategy currently exists. A follow-up to the pilots and other departments that developed enterprise systems is included in this report.



On February 22, 2000, the California State Senate Advisory Commission on Cost Control in State Government transmitted a report providing an overview of information technology in state operations. The Commission, in part, found the following:

State organization and constitutional responsibilities complicate management of State operations. This structure has led to a diffusion of accountability with diminished authority for the Governor to manage the entire operations of the State. Additionally, there are . . . accounting offices at the agency and department level as well as for boards and commissions (that) . . . have created accounts and data requirements beyond the State's uniform code manual (UCM). Decentralization of system designs has resulted in a proliferation of systems with different platforms and no uniform databases and little ability to exchange information. . . . (T)here are about 1,800 [estimated] systems which cost about \$2 billion annually to operate and there are continuous enhancements and new projects. Despite the huge cost for these systems it is still not possible to summarize the data for the entire State. The current culture of strong decentralization is out of balance. There has been a conspicuous absence of leadership and direction for State operations. All of the agencies and departments seem to do their own thing within legislative requirements. In addition there does not appear to be any central support for those functions which are common to all agencies and departments.

The Commission recommended establishing a Chief Information Officer (CIO) at the cabinet level, a Chief Operating Officer (COO), a statewide strategic master plan for information technology, a business plan with goals and measurable objectives, a new budgeting process and a new uniform statewide financial management plan.

In February 2003, the California State Auditor, Bureau of State Audits (BSA) issued a report, *Information Technology: Control Structures are Only Part of Successful Governance*. The BSA report recommends a governor's office level CIO, incentives for agencies to develop effective statewide IT initiatives, a commitment to employee skill development, an evolutionary IT strategy and a statewide inventory of IT equipment and systems. The BSA report also speaks to the appropriate degree of centralization, consolidation and standardization of statewide IT services and applications as well as outsourcing IT activities.

The current state CIO has taken some steps reflected in the BSA report recommendations. For instance, a California Information Technology (IT) Council was chartered in March 2004 to advise the CIO on Executive Branch IT matters, including the development of strategic plans and the adoption of enterprise-wide IT standards and policies. However, no current statewide enterprise or strategic plan addresses financial systems (except for GC Section 13300 that resulted in the creation of CALSTARS). To date, no plan or proposal has identified the timing for the retirement or replacement of CALSTARS.

Existing Financial Systems Used by State Agencies

CALSTARS is the core accounting system used by most state agencies. It is used by 90 accounting offices for 178 state agencies, or 85 percent of identified state agencies. Another 31 state agencies, including the judicial and legislative branches and the state universities, use other systems. Of the state agencies not using CALSTARS, 12 agencies were identified that have implemented enterprise systems or portions of enterprise systems and 19 agencies use other core accounting systems. Many of the state agencies using CALSTARS are small organizations. As a percentage of state expenditures, the CALSTARS system records 78 percent of state expenditures, the enterprise systems record five percent of expenditures and the other systems record 17 percent.

DOF recognizes that CALSTARS does not meet a number of the financial system needs of state agencies; DOF prioritizes system enhancements and modifications based on the needs of the majority of departments and within limited resources. Therefore, CALSTARS does not provide all financial functionality. We sampled 21 state agencies to identify what other systems comprised the financial system environment of the state. The survey response indicated 690 additional financial systems exist at the 21 state agencies. Among the survey's key findings are the following:

- Many financial systems are decentralized and not easily identified. Most agencies maintain no central inventory or documentation of all of their financial systems.
- Separate systems most frequently identified in addition to their core accounting systems are cashiering, accounts receivable, federal funds, fixed assets, disbursements/payables, procurement and financial reporting. Many systems automatically upload information to CALSTARS or to another core accounting system.
- Program and financial management requirements are commonly addressed in single program-specific systems.
- Departments commonly download CALSTARS data to another comprehensive database for access, program management, budget monitoring and reporting needs.
- Departments generally do not have budget preparation software; electronic spreadsheets are primarily used.

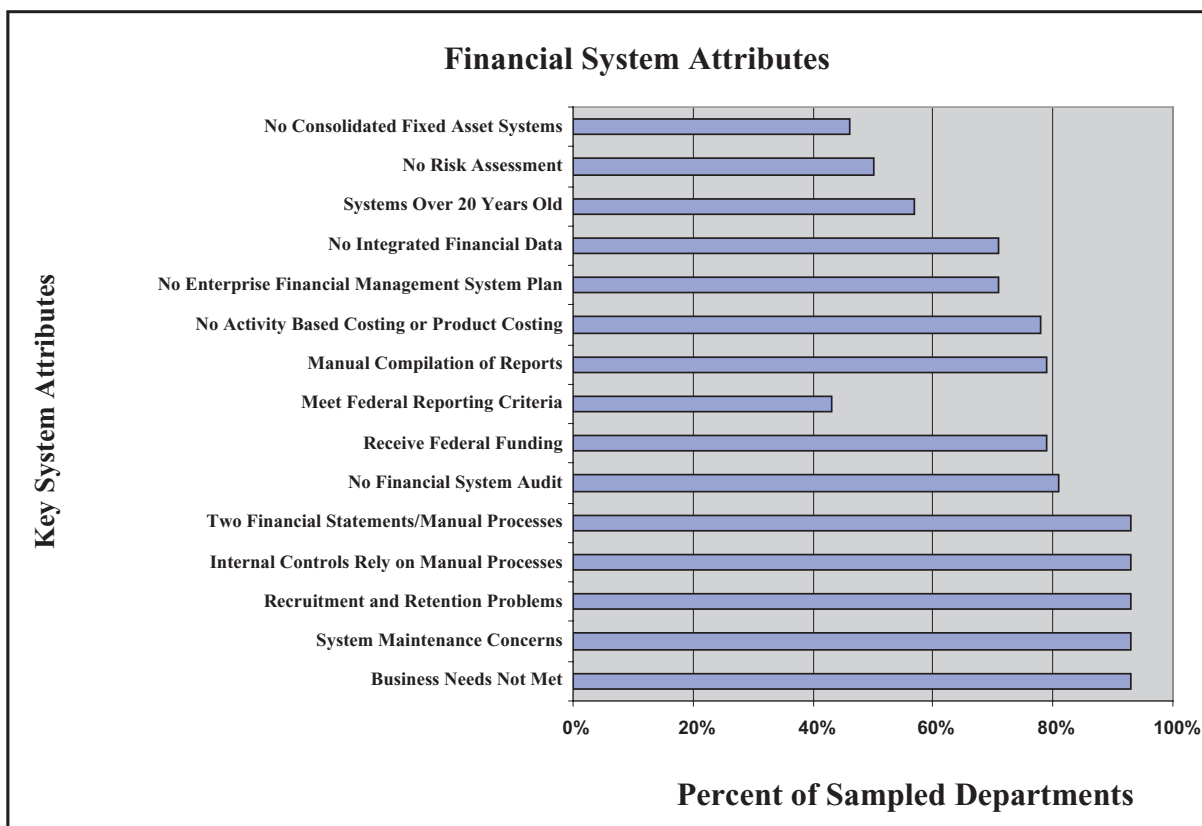
Separate from the departmental core accounting systems and critical to the design of the state's overall financial management system is the relationship and role of the State Treasurer's Office (STO) and the State Controller's Office (SCO). A prime example of this relationship is the management and processing of cash. Individual agencies collect revenue and deposit it into STO-approved depositories. STO notifies SCO of deposits; and SCO records the cash in its official records. To make cash disbursements, SCO primarily uses a claim schedule process. SCO then records state expenditures from the claim schedules. Individual state agencies must reconcile their accounts with the SCO system. Essentially, at a high level, these separate automated systems duplicate processing but also provide for strong cash controls, assuming the performance and management of manual reconciliations.



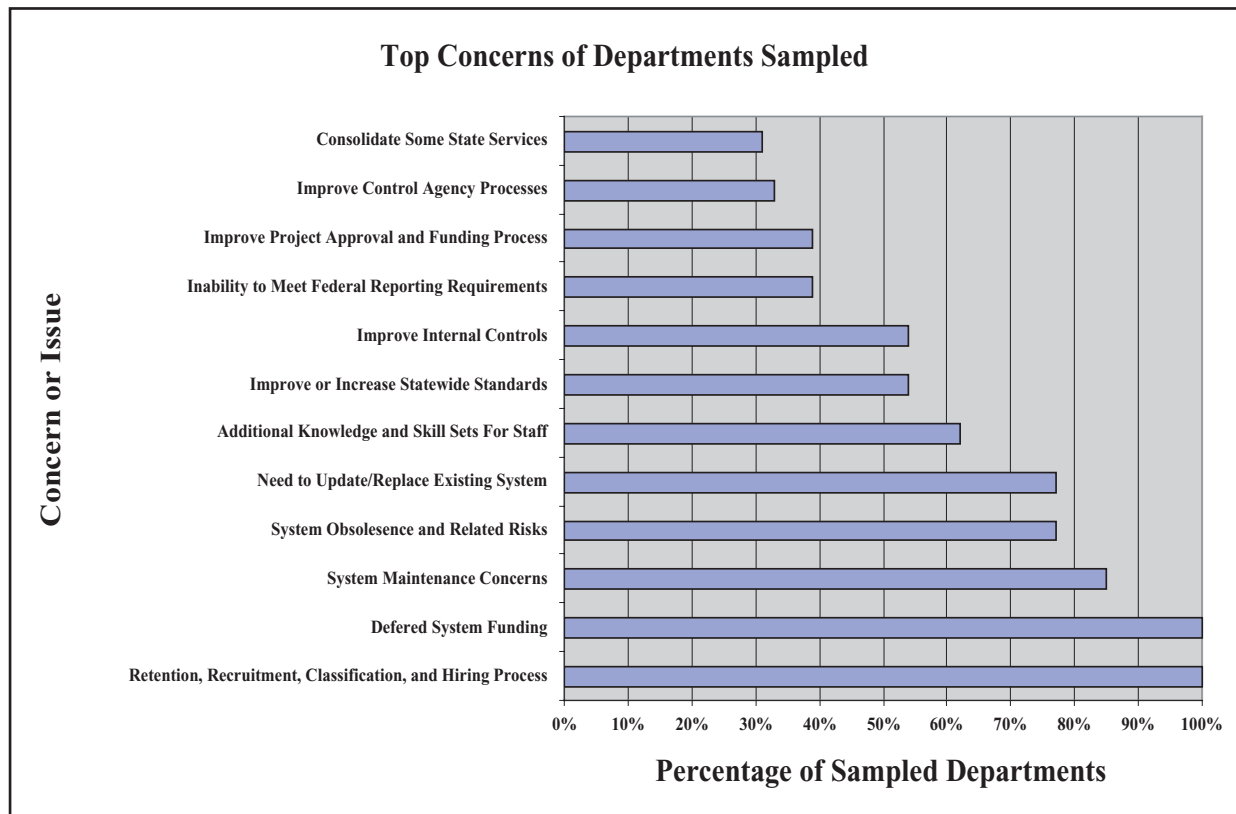
The number and variety of financial systems makes the state's entire internal control structure a risk. The state's resultant high-level financial statements rely on the relationship between the individual state agencies, SCO and STO. But the quality of detailed financial data generated by these other (hundreds) subsidiary systems has a greater accuracy risk. Moreover, the decentralization and program specific "stovepipe" design (a separate system designed to work independent of other systems) adds to the risk. As previously mentioned, state agencies commonly maintain no central inventory of all their financial systems. Another control risk relates to financial reports. Most departments do not generate reports from their official financial system. Data is downloaded from one or more systems and placed into multiple other systems, ranging from large databases to spreadsheets, which predictably have not been subjected to detailed audit or other verification and/or security testing.

Critical Attributes of Existing Financial Systems

We interviewed representatives of 14 agencies, which included management of the Accounting, Budget and Information Technology Offices. These agencies included departments using CALSTARS, enterprise systems and other types of core accounting systems. The interviews focused on internal controls, risks, reliability, stability, economy and efficiency of the financial systems of the agencies sampled. A summary of key observations is shown in the table below. Additional information is in Appendix VI.



We also asked the same departments to share the top concerns and issues that they believed were critical to financial management systems. Concerns identified multiple times by different individuals and by different departments are summarized in the table below. Some issues repeat the interview attributes above; but, agency staff also identified them as their most urgent concerns. The percentages indicate the number of agencies in the sample that identified items as top concerns or priorities. Additional information is in Appendix VII.



The following is a summary of CALSTARS agencies' specific issues and concerns about CALSTARS.

- The look and feel is not user friendly (i.e., "green screen" [text only] versus Graphical User Interface that allows direct manipulation of formats and images).
- Not accessible or user friendly to managers outside of accounting.
- Does not provide sufficient or easily accessible detail or drill down of data.
- Does not meet a number of business needs and often requires additional systems or "work-arounds".
- Requires knowledge and experience that takes significant time to acquire (up to 18 months).
- Federal program reporting requires more information than CALSTARS provides.



- Not an on-line/real time system; monthly reports can be delayed as much as one or two months depending on the departmental processes.

In many CALSTARS agencies, personnel management issues have a greater impact on accounting offices than do technical issues. These issues include employee turn-over and a lack of knowledge, experience and consistency in classifications relative to the required responsibilities. Vacancies and hiring freezes have resulted in less qualified staff filling positions or in positions not filled. In some areas of the state, the pool of resources is limited because of pay inequities with private industry. Many departments do not have the technical ability or resources needed to automate the upload and download of data to CALSTARS that could facilitate processing or reporting.

Finally, our discussions with state agencies about the automated financial systems environment (supplemental to the survey) revealed issues that impede economic and efficient operations but that would require changes in laws, regulation or policy:

- California has almost 1,000 separately accounted-for funds of varying complexity and workload demands. Program visibility or funding can be obtained without so many separate funds.
- Generally Accepted Accounting Principals (GAAP) versus Legal/Budgetary Basis generates additional workload including two sets of financial statements and multiple systems. Additionally, the Legal/Budgetary Basis has become a driver for financial and accounting requirements. Government Code 12460 indicates that the two methods should deviate as little as possible and that the state should convert to using GAAP as a basis for its accounting systems.
- The statewide view of budget to actual is restricted by the budget program numbering system. Budget program numbers at one agency for a specific program can be used at a different agency for a completely different program. This prevents a statewide roll-up of information.
- Federal requirements are extensive and vary widely among the hundreds of federal programs and grants.

As a result of this overall environment, the state's ability to produce timely, reliable financial data in an economical and efficient manner may suffer, and the risk of error or misstatement increases.

Conclusions

Existing systems are not meeting the state's business needs or expectations. That by itself would require planning to specify the business requirements and an approach to meet those requirements. But with the state at a critical juncture, the current situation has added timing urgencies. Many of the financial systems are at risk of failure because of age, loss of manufacturer support and/or loss of key (dependent) staff that maintain or use them.

The loss of key staff is especially critical because they perform the necessary manual processes such as reconciliations between the multiple systems, preparation of financial reports, execution of the automated processes required for daily operation and resolution of system problems. Moreover, other personnel are not being trained as back-ups and replacements because of current policies, workload levels and the obsolescence of the technology. Further, because of the age and extensive customization of many systems, contractors do not have the required knowledge to step into operations without significant training. The number of systems involved, the multiple handling of data for different systems and the overall complexity of the financial management system exacerbate the current conditions.

The state's hiring freeze and the loss of operational staff have degraded its ability to maintain adequate duty separations and key operational and maintenance functions.

Plans to remedy these diverse conditions vary. Budgetary constraints have precluded many agencies from taking the required steps or planning for resolution. Previous planning efforts lead by the state's control agencies to address these issues have been inconclusive.

The overall structure of the financial management environment—the number of systems and the obsolescent design of many of the systems—has inevitably resulted in a lack of economy and efficiency in the use of resources, frequent untimeliness of data and the potential unreliability and inaccessibility of data.

The remedy is not simple. Before these issues can be resolved, the state must determine an overall approach, strategy or enterprise plan for its financial management. Each agency must develop an inventory of its core and supplementary financial systems and determine their "life spans," potential risks and maintenance needs for sustainability. DOF should perform a similar assessment for CALSTARS; currently the software and hardware of CALSTARS is supported by the manufacturer. Most CALSTARS support staff are not scheduled to retire in the near future; so, CALSTARS is not an immediate risk. But because large IT projects require multiple years from concept to realization, planning should not be deferred. The state must prioritize its plan of action based on the results of this risk analysis.

New Financial System Projects

In the last four years, DOF has approved 38 projects with financial or financial-related functions and a total project cost (includes both development and ongoing maintenance and operations spanning multiple years) of \$2.4 billion. Approximately 70 percent of these projects automate manual processes and/or replace obsolete systems; 30 percent meet new program requirements (i.e., legislation). Most included customization and program functionality in addition to financial functionality; these are not exclusively financial system projects. The result is a potential tangling of financial and program functions in a single purpose system. Only 21 percent of the projects might be considered "just" financial.



Projects with approval delegated to the departments were not included in this review. Our review of departments' identification of their existing financial and accounting systems indicated many supplemental systems do not require control agency approval.

The 38 project feasibility studies approved within the last four years identified the following, sometimes multiple, financial or financial-related functionalities:

- 3 comprehensive financial systems
- 3 general ledgers
- 2 human resource systems
- 2 electronic claims for payment processing
- 6 accounts payable
- 9 accounts receivable and billing systems
- 7 cashiering systems
- 3 asset management systems
- 3 collection systems
- 2 project cost accounting

Because of departmental autonomy in the planning and development of supplementary accounting systems, the state is essentially purchasing and implementing the same functionality multiple times but without coordination among the entities. Each system is designed and tailored for a particular agency or program.

Audits of Financial Systems

DOF's Office of State Audits and Evaluations (OSAE) publishes two guidelines for audits of a department's information systems, one as part of the FISMA audit and a more comprehensive IT guide. In the preface to the IT Audit Guide, OSAE states:

These IT audit guidelines . . . reflect the transformation of IT and information systems from the centralized and structured IT environments to the decentralized information processing environments which are increasingly controlled at the program and organizational sub-unit level. . . . This situation makes the need for the IT audit function more critical than ever, and at the same time more difficult than ever The diversity of hardware, software and application systems across the universe of State agencies precludes the "check-list" approach to IT auditing. The IT audit function must be an ongoing process if the intent of the state's security and data integrity policies is to be met.

The audit guide recommends an analysis of both general and application controls and an examination of IT functions and activities across the entire agency. Audit activities and procedures recommended include information and data integrity practices.

We requested all IT audit reports that included financial systems from 32 departments. Only 19 percent of the departments had had an audit in the last three years that included at least one financial system and that followed many of the OSAE guidelines. Many departments performed some of the recommended audit procedures. When these departments are added, departments that performed at least some audit procedures of their financial systems increase to 53 percent.

This review indicates that the state is not performing the recommended audits of financial systems and is at increased risk that inadequate physical, general and application system controls will not be detected.

Administrative and Financial Enterprise Systems Lessons Learned

In 1997, the ITCC recommended three pilot enterprise systems to evaluate different approaches and one interagency consortium to develop an enterprise system. The state approved the three pilot projects; but the proposed interagency consortium project did not take place. The ITCC did not evaluate the pilots because of changes in priorities and ultimately the ITCC was discontinued because its enabling legislation sunset.

In addition to the three pilots, the state has approved other administrative and financial enterprise projects. Twelve agencies were identified with enterprise systems or some enterprise system modules. We interviewed five departments with enterprise systems for their lessons learned, including two of the original pilots. The state agencies interviewed have on average two to five years experience with their systems.

All departments stated they were better off with their enterprise systems than with their previous systems. Improvements included better access to data and data research, budget controls, reports, data integration, real time processing, cost accounting and improved business processes. The departments also pointed out some negative attributes of the commercial-off-the-shelf (COTS) software: complexity (much more than expected) and lack of user friendliness make operations difficult; standard reports do not always meet state requirements. Additionally, the systems require specific standard processes; if these processes are modified, data integrity may be lost. The departments also found that enterprise system maintenance costs are frequently more than for the systems replaced. Some departments also pointed out that they believe some program operational areas obtained savings, however processes and costs were not baselined before the project was implemented and savings were not quantified. Each department modified or customized the software and each did some business process reengineering.

Given the opportunity for 20/20 hindsight, each department strongly encouraged avoiding the development and implementation pitfalls that they reported and have since converted to



“lessons learned.” One key lesson shared applies to all the advice from these agencies: individuals who have not experienced enterprise systems have a diminished understanding of the importance of the best practices or lessons learned, or as one individual pointed out, “You don’t know what you don’t know.” The key lessons learned are summarized in Appendix VIII.

The information in Appendix VIII is critical to understand and adopt if the state chooses to go forward with additional enterprise systems. Overall, “top down” process reengineering, beginning with the control agencies, is necessary. Furthermore, the transformation to enterprise systems and processes from the existing environment can have unforeseen effects; one agency experienced a 95 percent employee turnover in its accounting office.

Other Public Sector Enterprise Resource Planning Project Lessons Learned

An Internet search of other lessons learned considering enterprise solutions revealed comments on enterprise projects implemented by George Washington University, West Virginia University, Sacramento County, the Commonwealth of Pennsylvania and the United States Mint. Additional comments were obtained from a report prepared by The Diagonal Group. Common concerns from these organizations reflect many of the concerns identified by the surveyed state agencies and are presented in Appendix IX.

Conclusions and Recommendations

The state has increasing risk in its financial management system structure. Issues have been identified in the past but a statewide, comprehensive strategic plan for financial management systems has not been developed. Some of the key issues include:

- Large number of existing systems
- Insufficient oversight or audit of the existing systems
- Obsolescence and deferred maintenance of the systems
- Dependence on diminishing staff resources to maintain the systems
- Dependence on diminishing staff resources to ensure data integrity
- Decentralization and design of the systems
- Complexity of the financial requirements
- Complexity of the organizational responsibilities

Some systems are past the critical point for required action. But because development of new automated systems is very expensive, a coordinated approach, direction or enterprise plan for systems replacement is prudent. Today, each department operates as a separate entity and the SCO operates a parallel system. The state must determine if it will continue with this approach, or if a consolidated approach or some hybrid is preferable.

The results of previous pilot projects have been included in this report and will not be repeated here; however, key points for success concluded from the pilots and the other departments interviewed are:

- Active executive support
- Reengineer the control agencies processes
- Update automation of the control agencies
- Establish realistic expectations
- Establish and define leadership for the effort
- Incorporate lessons learned and best practices

The State's System of Internal Controls and Monitoring

Many state agencies have neglected to comply with the state law requiring effective systems of internal controls. Consequently, the risk of fraud, waste and abuse increases when internal controls are lacking or missing. Additionally, financial statement reliability may also be compromised if independent validation and verification are not performed. We looked at the state's control structures and requirements and surveyed agencies' auditors to determine their role in providing assurances. We noted that many agencies do not perform internal control audits nor do they certify to the adequacy of their internal controls effectiveness. When internal audits are performed, auditors often identify deficiencies relating to accounting and administrative controls. For the most part, management takes timely and appropriate corrective action to fix the deficiencies; but some deficiencies continue from year to year. Repeated internal control deficiencies suggest that management hasn't sufficiently embraced its control responsibility. Moreover, the audit function may not be placed at the proper organizational level to effect necessary control environment change.

The state's current internal control legislation has been in place for over 20 years. The Legislature, aware of the importance effective internal controls played in detecting fraud and assisting in its prevention, as well as safeguarding assets, enacted the Financial Integrity and State Manager's Accountability Act of 1983 (FISMA). FISMA, Government Code 13400–407, requires each state agency to maintain effective systems of internal accounting and administrative controls. Furthermore, FISMA defines internal controls and requires agencies to evaluate controls continuously. When weaknesses are detected, they are to be corrected promptly. To ensure FISMA compliance, agency heads must certify to the agency's internal controls biennially. The act also discusses the Department of Finance's (DOF) responsibility for guiding agencies in their reviews and reporting. To assist agencies with the FISMA requirements, specific procedures are described in the State Administrative Manual (SAM).

SAM Section 20000 et seq. describes FISMA-related procedures for all state agencies and discusses DOF's Office of State Audits and Evaluations (OSAE) role in monitoring and



coordinating FISMA implementation. DOF requires all state entities to submit reports concluding on the adequacy of their organization's internal controls. The reports consist of a certification letter, internal control audit report(s) and management's response to the audit report(s). Further, SAM 20060 discusses DOF's independent program to examine the internal controls in institutions that have no process for monitoring internal controls. To help agencies fulfill FISMA requirements, OSAE issues an audit guide for the evaluation of internal controls and when necessary, issues audit memos to establish uniform policy and procedures.

To evaluate the effectiveness of state agencies' systems of internal controls, we interviewed key personnel from OSAE, reviewed applicable laws, examined pertinent documentation and obtained historical audit and expenditure data from various state agencies. In addition, we analyzed the data for comparative purposes and performed trend analysis to identify patterns which might suggest systematic problems within the agencies' internal control systems.

Many agencies ignore FISMA; OSAE monitoring efforts have not been effective to ensure compliance.

As part of this engagement, we analyzed state agencies' FISMA compliance during biennial periods ending December 31, 2001 and December 31, 2003 (under the act, agencies are required to report every odd-numbered year). First, we obtained the spreadsheet used by OSAE to track the various state agencies' certification letters and audit reports. Next, we obtained historical expenditure data from the Legislative Analyst Office's website. We combined this information and included 161 state agencies in this analysis. We computed the compliance rates by percentages of agencies submitting certification letters and corresponding dollar amounts. The results were disappointing.

For the biennial period ending December 31, 2001, only 40 out of 161 state agencies (24.8 percent) submitted certification letters. Compliance rose slightly in the biennial period ending December 31, 2003, to 34.8 percent. Considering the magnitude of the agencies reviewed expenditures, the analysis indicates the state is at significant risk of errors and irregularities occurring and not being detected. For Fiscal Year 2001–2002, agencies not certifying to the effectiveness of their internal controls incurred more than \$60 billion in expenditures. For FY 2002–2003, the amount fell to just over \$40 billion expended by agencies not certifying.

Compliance varied widely among agencies. In several agencies, over 88 percent of the operating departments complied with reporting requirements during the biennial period ending December 31, 2001. However, other agencies showed no compliance. The wide range of compliance suggests that the agencies with higher rates understand the importance of certifying to the effectiveness of internal controls. One agency in full compliance maintains an audit unit at the agency level. This placement apparently ensures compliance and suggests that the internal auditing function benefits if placed at the secretary level. On the negative side, we noted that several control agencies did not comply with FISMA's reporting requirements.

Also, several agencies with internal audit units have not completed FISMA related audits. A primary reason for such a poor showing by many state agencies may be the lack of sanctions for noncompliance. In addition, if an agency has no high visibility fraud or control breakdown, it may believe efforts to ensure controls are not necessary.

The OSAE audit chief, while aware of the noncompliance by many agencies, stated that OSAE does not have the proper enforcement authority to ensure all agencies comply. Neither FISMA nor SAM establishes enforcement responsibilities or sanctions. As a result, OSAE has limited its monitoring and coordination to recording the state agencies which file their certification letters and audit reports. In the past, OSAE performed more internal control audits of agencies without internal auditors. However, due to continuing budgetary constraints, OSAE has refocused its efforts to emphasize reimbursement work and has discontinued many of its FISMA related audits unless requested and paid for by the agencies. OSAE agrees that an agency level internal audit function would benefit the state because it would provide broader audit coverage through risk assessments of the agencies' departments and offices.

Internal auditors identified many internal control deficiencies which are timely and appropriately corrected. However, potential systematic problems remain.

We analyzed audit information obtained from 26 internal audit units from various state agencies. Using the OSAE's *Directory of State Internal Audit Organizations*, we requested the state's 32 internal audit units to provide audit findings, recommendations and corrective actions for the period from January 1, 2000, through December 31, 2003. From the 26 audit shops that responded, we developed a database of 2,292 audit findings, which we queried to identify trends and patterns.



The first query showed the array of findings as the internal audit units allocate their resources to perform the different FISMA subcycles. Many audit units did not properly categorize their findings to a valid subcycle; therefore, the findings included in this analysis will not agree to the total findings reported. Only findings categorized to proper subcycles are included. Using the key words to the left of the table below, our query generated the following results:

Key Word	FISMA Subcycle	Number of Findings	% of Findings
Cash	Receipt/Disbursements	506	32.5%
Budget	Budget	36	2.3%
Reporting	Financial Reporting	13	0.8%
Receivable	Receivables	115	7.4%
Revolving	Revolving Fund	67	4.3%
Personnel	Personnel/Payroll	143	9.2%
IT Controls	IT Controls	186	11.9%
Contracts	Contracts	109	7.0%
Fixed Assets/Property	Fixed Assets	207	13.3%
Purchasing	Purchasing	177	11.4%
	Total	1,559	100.0%

These results lead to several conclusions. First, the number of cash-related findings suggests this area is at high risk. Then, although the small number of findings in the budget and financial reporting cycles indicates fewer problems or exposures in those areas, our results with the financial statement exceptions (noted in the next discussion area) may instead indicate that audit units are not focusing their efforts in these areas. With the exception of the revolving fund subcycle, the other subcycles seem to show a consistent pattern of findings between 7 and 13 percent of total findings.

The next query was created to search the findings for sensitive words which would indicate errors and irregularities. We searched sensitive key words in the finding and condition field of the database. The results are noted in the following table.

Key Word	No. of Findings	Status of Corrective Actions
Fraud	24	For the most part, corrective actions were taken, but several findings remained open.
Waste	1	Corrective action plan was not requested.
Abuse	3	Corrective action taken for two; no mention for one other finding.
Overstated	12	Corrective and partial action and no plan requested.
Understated	6	Partial and corrective action taken.
Unreliable	2	Action taken for one; no corrective action plan requested for the other.

Table Notes:

Fraud — Most of the findings/conditions identified by this key word related to risk of fraud if the findings were not corrected. In addition, the Department of Health Services (DHS) performed an audit of a program set up to identify fraudulent labs. The audit identified several deficiencies which hinder the program's ability to efficiently address fraud. The other findings related to the Department of Insurance audit of its Fraud Division.

Overstated — This key word identified several accounts which were overstated on the financial statements. Several of the findings related to overstated accounts receivables.

Understated — This key word identified several understated accounts. In particular, DHS understated its encumbrances by over \$5 million for computer equipment ordered by various programs at year-end.

Many agencies report findings related to their fixed assets and accounts receivable. Since these two areas have direct ties to the state's financial statements, we performed additional queries. The first query used the key word "property" and resulted in a report of findings that showed 22 out of the 26 agencies (85 percent) reported significant findings related to their fixed assets. The following was extracted from several of the reported findings and/or conditions.

- Controls over property accounting did not ensure that assets were properly valued and received.
- Equipment was overstated on the financial statements.
- Controls over property did not ensure that assets were properly tracked, tagged, recorded and reconciled to accounting records.



- Missing property valued at \$434,046 had been recorded in a suspense account, an average of one year, while awaiting disposition.
- The Board has not maintained adequate control and accountability for property, increasing the risk of misstatement in the general ledger.
- Reconciliation of property balances with amounts reported to DGS not performed or incomplete.

As noted above, these findings may cause not only the individual agencies' financial statements to be misstated, but also the agencies' property ledgers, general ledgers and Statement of Changes in General Fixed Assets. In addition, given the frequency and extent of these findings, the issues appear to be systematic and could be even more significant considering all the agencies which do not have an internal audit function. CPR has established a separate Assets Management team to address issues of identification, management and control of the state's fixed assets.

In reviewing the accounts receivable (A/R) findings, we observed that many agencies found problems relating to the aging of A/Rs, A/Rs not recorded in general ledgers, A/Rs not reconciled to appropriate records, financial statements overstated and inadequate write-off procedures. One specific example states: "This listing reflects \$14.8 million in outstanding receivables. However, the listing cannot be relied upon, as it lacks a basis in valid supporting documentation." Given these findings, the financial statements' A/R balances may be misstated for several, if not many, state agencies.

Our final query browsed the audit information to determine whether corrective action had been taken. Many documents showing the status of corrective action plans indicated that corrective action was taken. In addition, follow-ups were performed for some but not all of the issues noted. While most of the agencies are responsive to the audit issues noted, many findings are repeated from year to year. In addition, in at least one example, an agency neglected to implement audit findings noted in the audit.

During our interview with the Office of Emergency Services (OES), staff notified us of audit identified problems with Office of Criminal Justice Planning (OCJP) accounting records. The findings included no bank reconciliations for several years, revenue collected but not posted, no remittances to the State Treasurer's Office, SCO reconciliations not reflecting the agency records and federal grant reporting and claim payment issues. According to OES, a team of 12 OSAE auditors has been established to assist OES with the corrective effort. OES further stated that an internal audit report identified all of these problems and that shortly after the audit report was presented, the OCJP audit shop was disbanded. While this may be an isolated and not correlative incident, if the internal audit unit had reported to an agency secretary it may have been avoided.

Many smaller agencies' financial information is not being adequately reviewed to determine its reliability and fair statement.

We noted that various smaller agencies do not receive routine audits of their internal controls or financial information as is typical in larger departments. The Bureau of State Audits (BSA) annual audit of the state's financial statements rarely includes smaller agencies because of its high dollar materiality levels. As discussed in the previous section, most state agencies do not have internal audit units and do not perform routine accounting and administrative control audits. The control agencies with auditing functions typically audit agencies with high expenditure amounts. Often, agencies' only financial statement review comes from SCO, but that review is more one of form rather than of substance. Nevertheless, these reviews showed that many agencies' financial reports lacked timeliness and accuracy of financial data. Given these conditions, we believe the state runs the risk that unreliable financial information (although not material to the state as a whole) may be prepared by smaller agencies and not discovered and corrected in a timely manner.

Each year, BSA audits the financial statements that collectively comprise the state's basic financial statements. In conducting the audit, BSA relies on audit work performed by control agencies, state internal auditors and independent contractors. In addition, BSA assesses the risk of material misstatement of the financial statements due to fraud and designs tests that provide reasonable assurance of detecting fraud that is material to the financial statements. BSA establishes materiality levels for the major funds and identifies profile accounts for audit testing. BSA performs the required testing and procedures to express an opinion on the state's basic financial statements. To obtain an understanding of BSA's audit coverage for selected state agencies, we met with the Deputy State Auditor, who explained the audit approach and identified the state agencies that were part of BSA's audit testing for FY 2002–2003. The majority of them were larger agencies. According to the Deputy State Auditor, the smaller agencies have a remote chance to be included in the annual audit. BSA's materiality levels and sampling plan broadly incorporate those small agencies whose potential noncompliance would not materially affect the state's financial statements taken as a whole.

We also met with SCO's audit managers to determine the extent of their audit coverage. SCO's seven audit bureaus perform a wide range of audits including the following areas:

- Single audit oversight of local agencies, school districts and special districts
- Unclaimed properties and non-institutional providers of Medi-Cal
- Mandated costs for school districts, cities, counties and special districts
- Court revenues to ensure their accuracy and appropriate allocation
- County collected property taxes to ensure their proper allocation
- Oil and gas royalties owed to the state
- Claim schedule and tape claims
- California Lottery to determine accurate revenue reporting and proper allocation



This audit coverage does not include internal control or financially-related audits of small state agencies. However, the SCO's Division of Accounting and Reporting (separate from the Division of Audits) does perform a cursory review of each financial statement submitted by the individual agencies.

To recognize agencies that submit both accurate and timely year-end financial reports, SCO's review measures the financial information against pre-established criteria. If agencies meet all of the criteria, they may receive the "Award for Achieving Excellence in Financial Reporting." To qualify for this award, general fund agencies must meet 10 criteria including timely submittal, proper account number and title coding, prior year accruals within a specified range and debits equal credits. The table below shows the percentage of agencies receiving awards.

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Total Eligible	223	226	225	198	212	208	226
No. of Awards Issued	29	45	34	49	45	48	73
Percentage Awarded	13%	20%	15%	25%	21%	23%	32%

We analyzed further to identify the types of errors that prevented the agencies from receiving the reporting awards. For the 226 agencies that submitted general fund financial reports, we noted the following errors and error rates.

Criteria	Number of agencies	Error Rate
Reports/Revised Reports were not submitted on time	56	24.7%
Prior accruals are not within 10% of expenditures and revenues realized in the current year	71	31.4%
Total error rate is more than 2%	37	16.4%
Expenditures and Revenues do not agree with Governor's Budget	8	3.5%
Debits and credits not equal	10	4.4%

As this table shows, many agencies are not submitting their financial reports by the due dates. In addition, agencies appear to have problems accounting for their prior accruals and submitting reports with minimal errors. While these exceptions occurred in both large and small agencies, the larger agencies generally have audit coverage by either internal or external auditors, whereas the smaller agencies more often lack independent audit assessment of their financial data. Without this audit coverage, the risk increases that agencies are certifying to the accuracy of their financial statements without a solid basis. This may lead program and fiscal managers to make decisions based on untimely and incomplete financial data.

Conclusion

Overall, the state's control environment could be improved by taking several important steps. First, in conjunction with CPR's proposed re-organization, place auditors at the agency level. This organizational placement will help assure wider audit coverage of the smaller entities within the agencies—especially those lacking financial-related audits. In addition, agency-level auditors will be better able to ensure appropriate corrective actions are being taken to address audit-reported deficiencies, and would provide a point of contact for coordination among other state auditors. Second, OSAE's FISMA monitoring efforts should be strengthened. OSAE should have adequate enforcement authority to require all agencies to comply with the FISMA reporting requirement. Moreover, the guidance and approach to the FISMA audits should be clearly discussed with the internal auditors to help assure consistency. Next, agency heads should reinforce the importance of providing timely and reliable financial reports to SCO. The low achievement award rate we identified may indicate the lack of importance management places on timely and correct financial data. By implementing these steps, the state's internal control structures would be strengthened, and would likely improve the timeliness and reliability of the state's financial data.



Performance Review

The final piece of the “line-by-line” audit is the assessment of program necessity and effectiveness. Resource constraints demand that each agency must manage its resources as effectively and efficiently as possible. As such, we undertook a review of the State of California’s strategic planning, performance measurement and performance based budgeting. This review provides an understanding of how the state plans its programs, measures its results and makes budget adjustments accordingly. Further, it shows the direction the state is moving in budgeting, fiscal systems, and program management; we must recognize the state’s efforts to date in measuring and monitoring performance.

Background

History and State Mandate

In 1994, the State Government Strategic Planning and Performance Review Act (Chapter 779, Statutes of 1994) was passed, adding Government Code (GC) Sections 11810–11817. This act required that all state agencies consider strategic planning, and also required DOF to survey agencies concerning their strategic planning efforts. This charge commenced in 1995 and was to be updated annually thereafter.

DOF’s Required Oversight of Activities

DOF’s annual survey and report to the Joint Legislative Budget Committee showed that a means for implementation and enforcement was necessary. In 1996, DOF, through Management Memo 96-23, required all agencies to develop strategic plans and have them completed and approved by July 1, 1997. The memo further identified the minimum components of strategic plans and stated that the plans would be the basis of each state agency’s budget. In addition, all agencies’ strategic plans were to be approved by and filed with the Governor’s Office. Beginning with the FY 1998–1999 budget, strategic plans were to be linked to the budget process. Furthermore, BCPs would be considered for approval only if consistent with an approved strategic plan.

GC Section 11813 (part of the act mentioned above), discusses the Legislature’s intent that strategic planning should include performance measurement, performance budget contracts, and performance reviews. DOF implemented the code via Budget Letter 98-07, which required that budget adjustments requested in the preparation of the FY 1999–2000 budget be linked to the entity’s strategic plan.

No centralized tracking/monitoring of statewide strategic planning efforts exists.

We met with DOF, the Bureau of State Audits, the State Controller's Office, the Department of Motor Vehicles, a former Deputy Director of Parks and Recreation (a strategic planning expert) and other California Performance Review team members to discuss the current status of strategic planning. After reviewing GC Sections, Budget Letter 98-07 and conducting our interviews, we determined that the legislation and direction is still valid; departments are required to implement strategic planning efforts. However, the Davis Administration did not support strategic planning and consequently neither DOF nor the Governor's Office has actively monitored/tracked compliance beyond the first year of implementation. Currently, the state has no centralized oversight of state strategic planning efforts.

The Legislature authorized a performance budgeting pilot in 1993.

In January 1993, the Governor's Budget introduced a Performance Budgeting Pilot Project. Four agencies participated in the pilot beginning in FY 1995–1996, at which time DOF was asked to review and evaluate the pilot and report to JLBC. We address DOF's review separately, in a later section of this report. The Davis Administration did not extend the pilot beyond FY 1998–1999. However, the agencies that participated in the pilot continue to use performance measurement in their budgeting processes.

Status of State Agencies' Strategic Planning, Performance Measuring, and Performance Based Budgeting Efforts

Methodology used to identify current status of activities

Budget Letter 98-07 requires an updated strategic plan (plan) whenever a change to a goal in a prior plan, a change to an objective in a prior plan, or a proposed budget request that does not tie to an existing plan occurs. Otherwise, a plan need not be revised if the department director certifies that there have been no changes.

We first contacted the State Library to obtain a list of agencies that submitted strategic plans or performance reports in the past five-year period and to obtain the current strategic plans for each agency. Since 1998, only 11 plans have been cataloged at the State Library. However, when the strategic planning act was first introduced in 1994, the State Library received 48 plans. The number of updates and renewals has steadily declined as Davis Administration interest and DOF oversight waned from FY 1999–2000 through 2002–2003.



To augment our identification of agencies' strategic planning activity, we surveyed state agencies and inquired as to their use of strategic planning, performance measures, and performance based budgeting. We sent out 106 survey forms to various state agencies (with staff size of 20 or more Personnel Years (PY)) including boards, commissions, departments and offices. Eighty-two (77 percent) of the 106 state agencies responded to our survey. Note that the results we report below are anecdotal in nature; that is, this is what the respondents told us. We did not audit the strategic planning or performance measurement of these agencies. Any conclusions we draw and recommendations we make must be taken with this in mind.

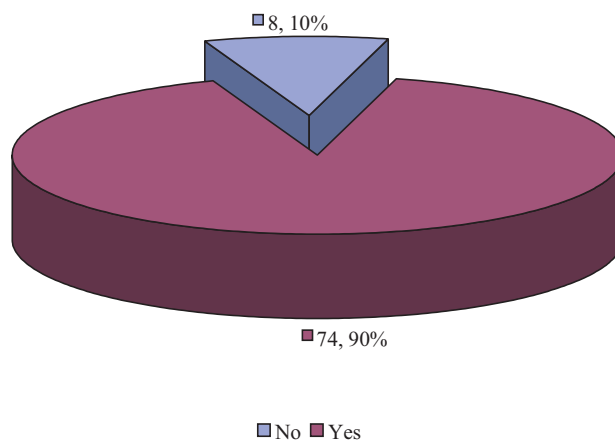
Survey Results: Strategic Planning

Most state agencies perform some strategic planning

Our survey asked whether agencies had strategic plans and the latest date of their plan update. Seventy-four of the 82 agencies (90 percent) reported that they had developed strategic plans. Moreover, most have updated their plans regularly; 64 (86 percent) of the 74 agencies with plans have updated their plans since 1998. See Exhibit A below.

Exhibit A

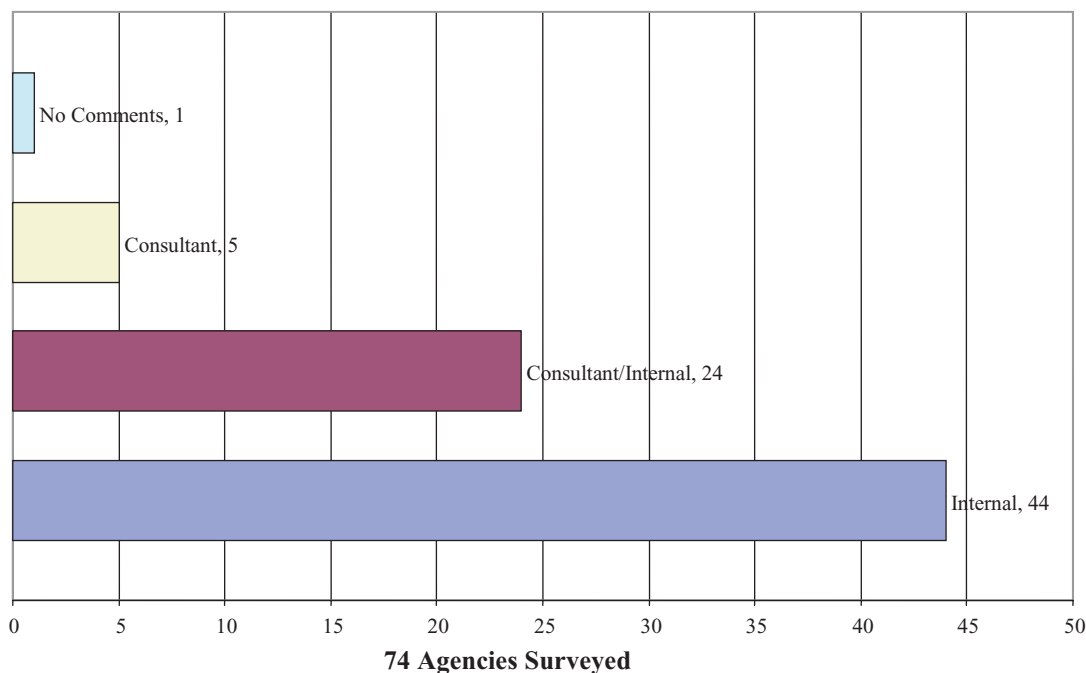
Seventy-four out of eighty-two agencies surveyed stated that they developed strategic plans.



Half of the agencies use internal staff to develop their strategic plans

We asked how agencies developed their strategic plans. Forty-four of the 74 agencies (60 percent) used only internal staff to develop their plans, 24 agencies (32 percent) used a combination of consultants and internal staff and five agencies (6 percent) employed consultants alone to prepare their plans. The enabling legislation allocated no additional funding; the agencies continuing to develop and update their plans have done so with existing resources. See Exhibit B below.

Exhibit B
How do Agencies Develop Strategic Plans?



Even though most state agencies prepare strategic plans, they are not forwarded to DOF or submitted for the Governor's signature

Budget Letter 98-07 requires that strategic plans be submitted to DOF for approval as well as to the Governor's Office for signature. Of the 74 agencies that reported they had developed plans, only 30 (40 percent) indicated that they sent their plans to DOF while 17 (23 percent) were sent to the Governor's Office. This correlates to the small number of plans cataloged at the State Library over the last five years.

Nearly half of the agencies responding indicated that their plans tie to an overall plan

We sought to understand whether agency goals and objectives were tied to any higher level strategic plans. Thirty-two agencies (43 percent) stated that their plans were tied to a higher

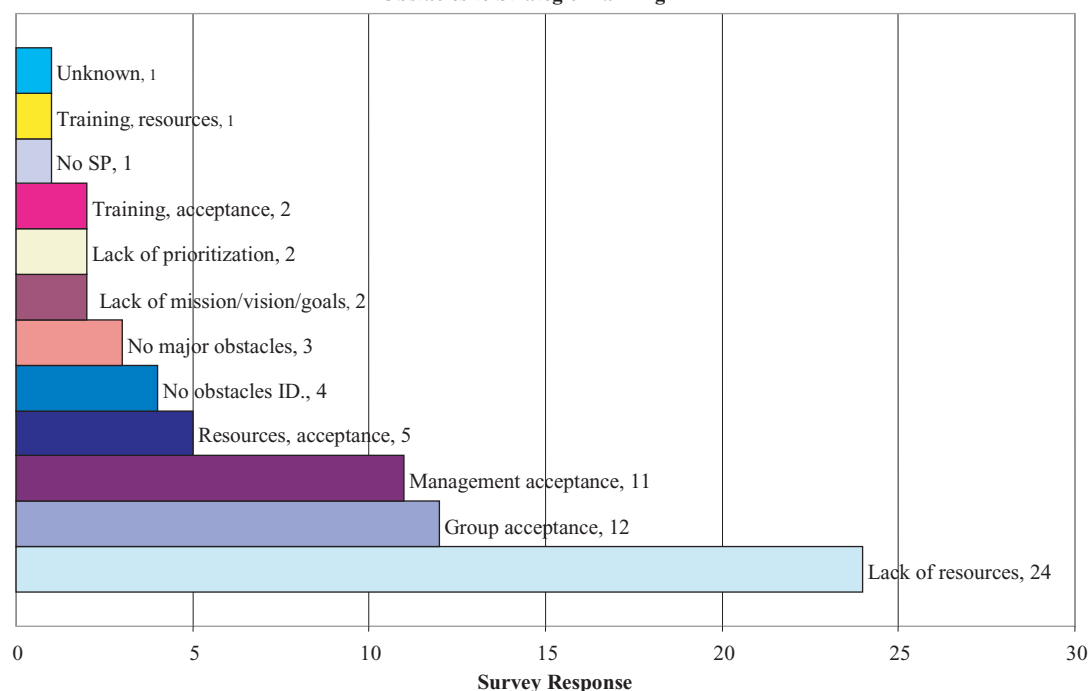


level plan. In addition, we asked whether an agency's strategic plan was supported by other plans from within the organization. Fifty-three agencies (71 percent) indicated that their plans were supported by sub-plans under their responsibility.

The biggest obstacle to strategic planning is a lack of resources

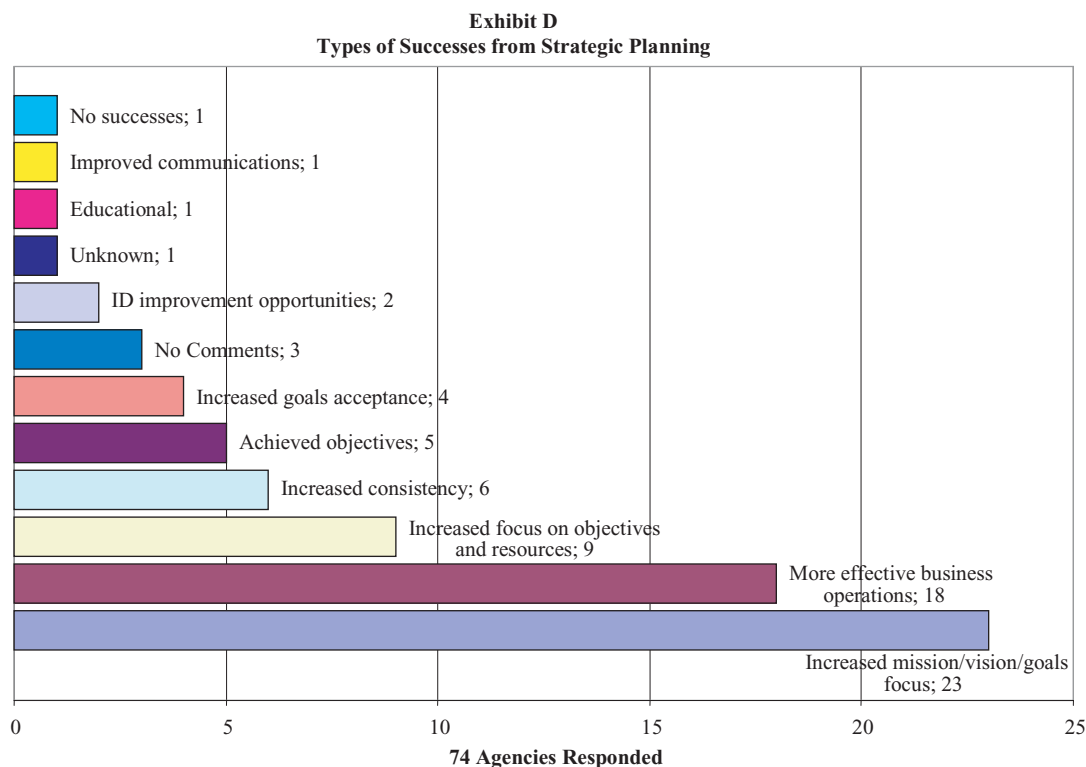
We asked what, if any, obstacles agencies may have experienced in developing their strategic plans. Sixty of the 74 agencies (81 percent) provided us with at least one obstacle. The single largest obstacle, identified by 24 (40 percent) respondents, was that a lack of resources limited their strategic planning efforts. Twelve (20 percent) responded that a lack of "group acceptance" to strategic planning led to difficulties in preparing plans, while 11 (18 percent) responded that "management acceptance" was an obstacle. See Exhibit C below.

Exhibit C
Obstacles to Strategic Planning



Increased attention to mission, vision and goals is the most common success mentioned in our survey

To understand what went well, we asked what successes could be identified as a result of an agency's development of a strategic plan. Seventy respondents indicated that they had achieved successes; the largest number, 23 (33 percent), indicating an increased focus on mission, vision and goals in their organization. Another 18 (26 percent) responded that their business operations became more effective as a result of planning, while 9 (13 percent) indicated that they increased their focus on meeting objectives and efficiently using resources. See Exhibit D below.



A lack of resources, again, was a common theme for agencies not preparing or updating their strategic plans

If an agency did not prepare a strategic plan or has not updated their plan, we asked them to explain why they did not. Twenty-six agencies gave various reasons for not updating or developing strategic plans with “Lack of resources” being the most common response given by seven agencies. The remaining reasons varied from office turnover to some offices using other methods of planning.

Survey Results: Performance Measurement

DOF's 1998 Budget Letter on Strategic Planning Requirements provided agencies with instructions regarding the format and components of strategic plans. Specifically, DOF indicated that departments should, at a minimum, develop at least one key performance



measure for each strategic plan objective. DOF also suggested that agencies develop plans to monitor and track performance. The second part of our survey focused on state agencies' activities related to performance measures. We summarized the survey results below.

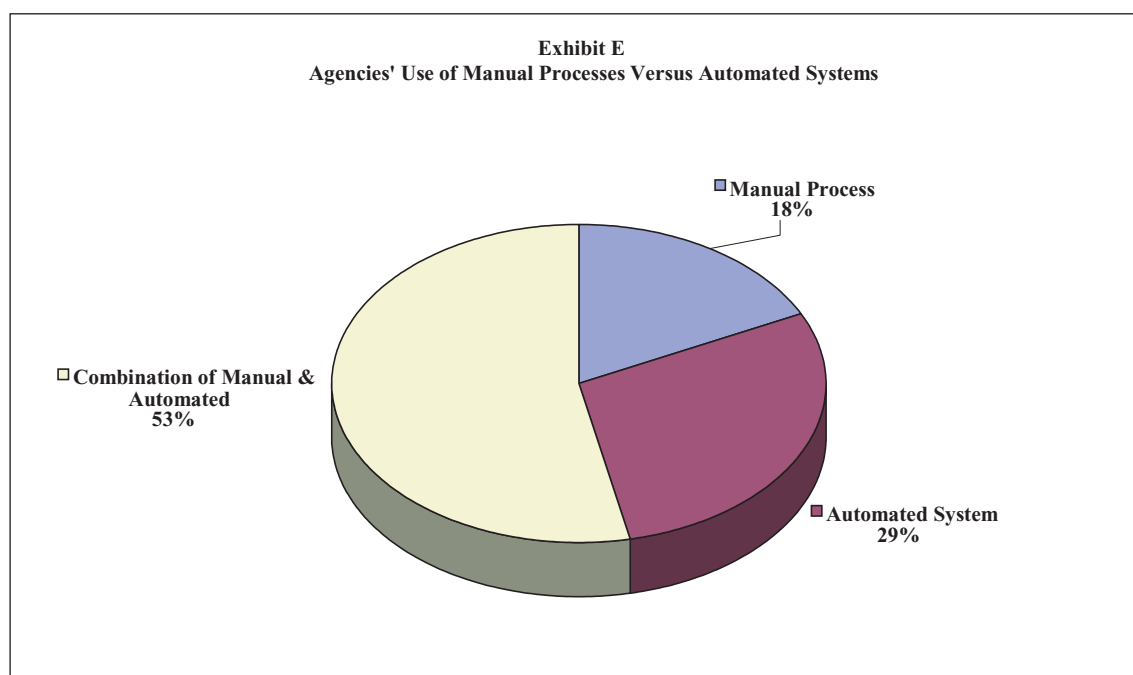
Most agencies are using some performance metrics

Responding agencies indicated that they use benchmarks and performance measures, to varying extents, in managing their programs. Specifically, 69 agencies or 84 percent have developed benchmarks and performance measures that are linked to their strategic goals and objectives for all or some of their key program areas. Respondents' comments revealed other interesting points, as follows:

- Several agencies' performance measures were either mandated, required by contract provisions, or piloted by the federal government.
- Some agencies developed their performance measures independent of their strategic plan.
- A few agencies that developed performance measures do not use benchmarks.
- Performance measures are sometimes limited to measuring timeframes.

Most agencies have some processes in place to gather and measure data

Approximately 90 percent of the agencies have automated information systems or manual processes in place to gather and measure performance data. Three of those agencies currently use web-based systems. The chart at Exhibit E below identifies agencies' use of manual processes versus automated systems.



Performance results are regularly monitored by management

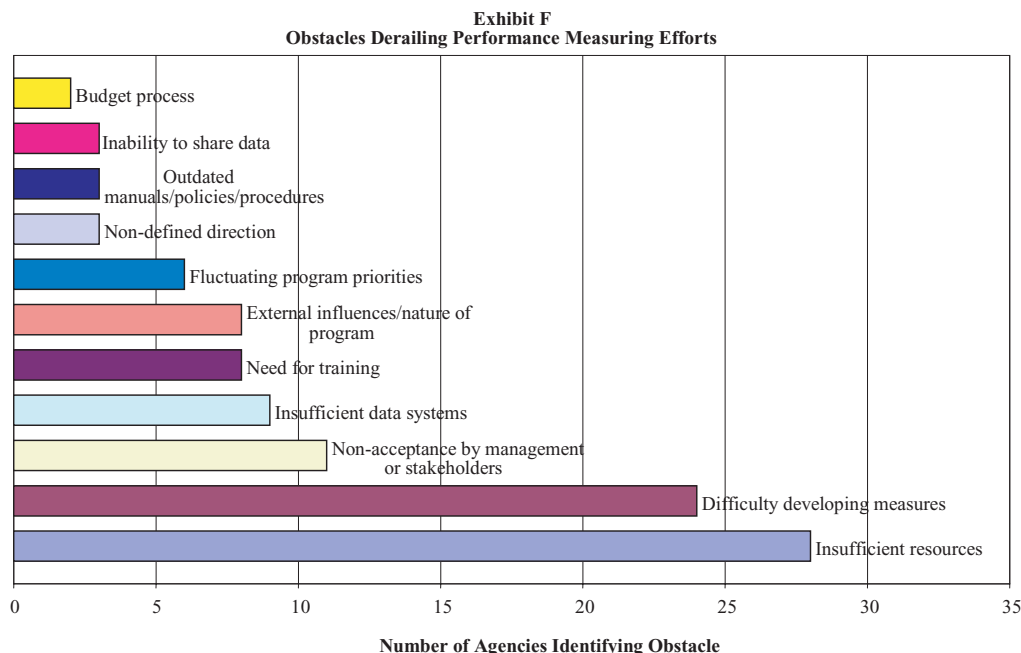
Fifty-four or 66 percent of the agencies monitor their program performance on at least a quarterly basis. Most agencies regularly generate reports detailing actual performance against targets. Almost half responded that the reports are being analyzed by management. Also, several agencies responded that their reports are being analyzed by internal staff such as strategic planning, statistical, budget or audit staff. Alternatively, many agencies' reports are being analyzed by external consultants, stakeholders, and/or state or federal agencies.

Agencies analyze and adjust measures and integrate changes into subsequent plans

We asked the agencies if they regularly analyzed the viability or propriety of their measures. Although 57 percent indicated that they do monitor and adjust measures, their timeframes for regular review and adjustment of measures ranged from an "as-needed" to "biennial" basis. When asked what action management takes if measurable operating objectives are not met, 44 percent of the agencies indicated that they determined the cause for not achieving the objective and adjusted the existing action plan or implemented a new one accordingly. While specific actions varied, the following were recurring themes: reallocating staff or resources, implementing training and documenting staff performance evaluations. Furthermore, 59 percent of the agencies indicated that the information was integrated into the following year's strategic plan.

Insufficient resources and the inability to develop performance measures often derail agencies' performance measuring efforts

We asked agencies what obstacles they overcame or are trying to overcome to make their performance measuring efforts a success. Sixty-five agencies responded to this question; most identified multiple obstacles. As indicated within the chart at Exhibit F below, insufficient resources and the inability to develop adequate performance measures are key obstacles.





Use of performance measures improves agency focus on strategic goals and objectives

We asked what general successes agencies experienced from their performance measuring efforts. Most of the 63 agencies that responded to this question cited success in improving their focus on strategic goals and objectives. The agencies also identified various other successes, as indicated in the table at Exhibit G below.

Exhibit G
Successes Resulting From Performance Measuring Efforts

Number of Responses	Successes Identified
17	Improved focus on program priorities, core goals/objectives, or program results in general
11	Improved relationships with stakeholders or improved customer service
8	Improved efficiency and/or effectiveness
7	Improved communication with staff and/or shared sense of staff responsibility/accomplishment

In addition, some agencies attributed more specific, statewide successes to their performance measuring efforts. These included the following:

- Contributing to affordable housing
- Decreasing the mileage death rate
- Better control of fires in urban areas
- Overall improvement in the health of children

Survey Results: Performance Based Budgeting

The third part of our survey inquired about state agencies' use of performance based budgeting processes.

Few have integrated performance into their budgeting processes

Ten agencies responded that they had implemented a performance based budgeting (PBB) process for one or more of their programs. Four of these agencies had participated in the State's Performance Budgeting Pilot Project mentioned earlier in this section of the report. As indicated within the table at Exhibit H below, other agencies currently use PBB to some extent or have used it in the past.

Exhibit H
Number of Agencies That Use Performance Budgeting

Agencies Responding	Usage of Performance Based Budgeting (PBB)
10 (12%)	Currently use a PBB process for one or more programs
9 (11%)	Currently integrate the use of metrics/outcomes into budget process
2 (2%)	Had some success with an informal pilot PBB process in past

Those who use outcomes indicated that their operational budgets link to their strategic plans, at least partially. In most cases, they reported success in using performance measures to make budget decisions. Several agencies commented that their performance measurements helped them to direct resources to those areas most in need or to identify program activities to maintain, reduce, or eliminate.

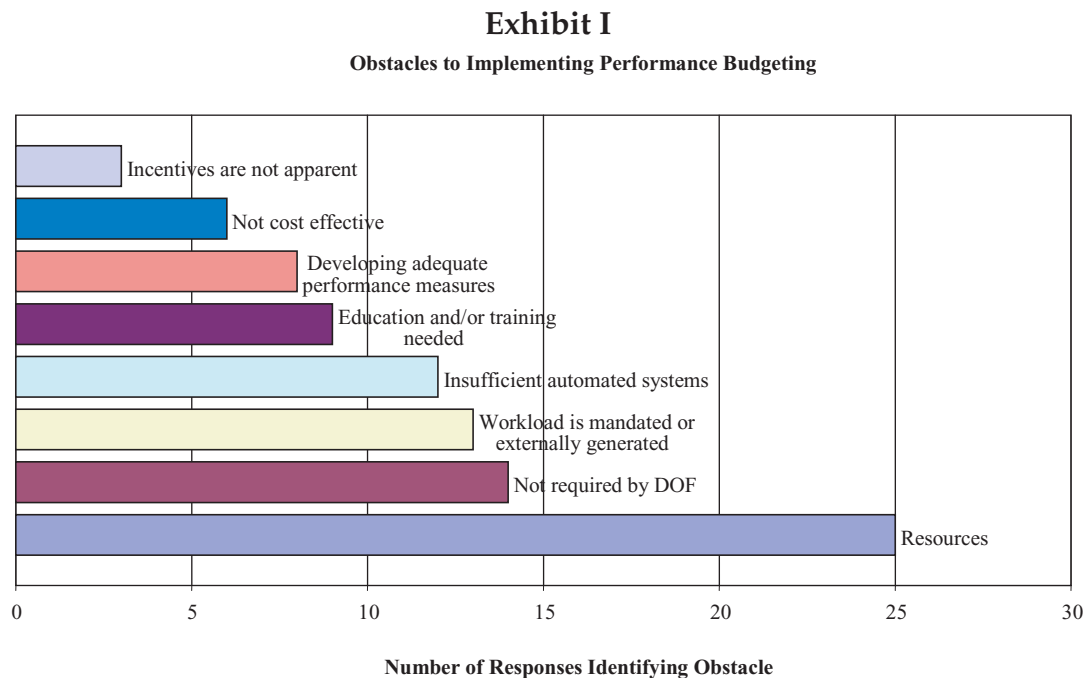
Typically, these agencies included requirements for meeting financial targets within their strategic plans. When asked to identify the consequences for not meeting those requirements, responses included the following: loss of federal funds, increased oversight or discretion over budget, staff evaluations or bonuses affected and action plans required.

Most agencies budgetary responsibilities are established and regularly monitored

Eighty-four percent of the agencies indicated that their budgetary responsibilities are established and reviewed regularly. However, when asked if they had a formal contingency plan in place to deal with budget deficits, less than half responded “yes.”

Lack of resources is the main obstacle to implementing performance budgeting

When asked what obstacles prevented agencies from considering a PBB process, agencies most often responded that insufficient resources prohibited them from implementing a PBB process. The chart at Exhibit I below identifies agencies’ responses.





Other individual concerns must be addressed if performance budgeting is implemented statewide. For example, agency program budgeting may not correspond to functions that cross program lines; the state's employee performance appraisal process may not be in accord with agency performance measures; and agency performance may be contingent on obtaining accurate data from local entities.

Few agencies are prepared to implement Performance Budgeting

Finally, we asked agencies how well prepared they were to implement a PBB process in the future. Not surprising, only 20 percent indicated that they were well prepared or prepared and ready to implement. Others did not know, did not respond, or identified concerns that mirrored the PBB obstacles identified above.

Status of Audit Coverage Over Agencies' Strategic Planning and Performance Measuring Efforts

Over Half Indicated That Their Program Performance or Measures Are Being Reviewed or Audited

Forty-nine agencies (60 percent) indicated that at least some of their program performance or performance measures had been reviewed or audited. These audits have been conducted by both internal and/or external entities. Specifically, BSA and DOF conducted reviews/audits in 15 of those agencies (31 percent) and federal audit groups conducted reviews/audits in 12 (24 percent). Additionally, internal staff or internal auditors conducted reviews/audits in 17 of the agencies (35 percent). Furthermore, some reviews/audits had been conducted by other various external state agencies, contractors, or other entities.

BSA Recommended Improvements to Strategic Planning and Performance Measures

BSA spends approximately 76 percent of its effort conducting performance audits. This type of audit is an objective and systematic examination of evidence to provide an independent assessment of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by responsible parties. We identified seven BSA performance audits conducted in the past three fiscal years that reviewed state agency or county departmental strategic planning efforts or specific performance measures. BSA identified key elements missing from strategic plans and identified one agency that failed to use adequate strategic planning in managing a major project. Some recommendations for improving performance measures addressed the need for more complete performance measurements that include all cost components, and better tracking of data.

Some internal auditors conduct performance reviews of operations and programs

According to OSAE's Directory of State Internal Audit Organizations for 2004, 32 internal audit units operate within state agencies. Seventeen of those audit units indicated that they performed program reviews and/or performance audits during FY 2002–2003. On average, the units spend 20 percent of their time on such audits. We did not examine the reports these

auditors produced, but recognize the potential for this work to positively influence the development and review / revision of effective performance monitoring.

DOF's Evaluation of the Performance Budgeting Pilot's Preliminary Results Was Favorable

In January 1996, DOF evaluated and reported on the Performance Budgeting Pilot (pilot), which included the California Conservation Corps, and the Departments of General Services, Consumer Affairs, and Parks and Recreation. DOF viewed the pilot as a short-term success, but deemed it too early to issue a final evaluation of its results.

DOF identified two key implications for the state's budget process, as follows:

- The usefulness and application of performance budgeting will depend on whether the allocation of budget dollars to specific outcomes or performance targets is for information purposes, or for appropriation control.
- While performance budgeting will facilitate the setting of budget priorities across programs and departments, it should not displace consideration of other factors, i.e., basic public needs, workload of case-driven programs and changing social and program conditions.

DOF also identified several objectives that should be satisfied before the pilot could be fully evaluated and rolled out to other non-pilot agencies. They included the following:

- Replacing all activity targets with performance measures (to the extent possible).
- Reviewing the linkage between all outcome oriented performance measures and departmental responsibilities.
- Establishing cost accounting processes, which link expenditures to dollars budgeted for outcomes or other performance targets and are capable of predicting alternative service levels associated with alternative budget allocations.
- Identifying, verifying and tracking cost savings associated with the program innovations that arise from the performance budgeting decision-making process.
- Implementing internal and external evaluation systems to assess the integrity and reliability of the performance and cost data.
- Using external evaluations to determine if any statutory program requirements have been de-emphasized simply because their performance levels are not easily measurable, or, conversely, whether some activities that are represented in performance indicators are unduly emphasized.
- Requiring external and internal audits to ensure that appropriate internal controls are in place to prevent any abuses associated with the administrative flexibilities granted to agencies.
- Collecting information on the cost-savings and improved performance, if any, resulting from each item of administrative relief and share this information with the appropriate control agencies for review.



- Handling the annual contracting process between the pilot departments and the Legislature in a consistent manner.
- Implementing a consistent state policy on “gainsharing” (whereby 50 percent of resulting savings are returned to the state) with appropriate controls.

Other States Provide Executive Oversight and Conduct Independent Reviews of Performance

We researched five states that utilize performance measures to identify the scope and responsibilities for monitoring their agencies’ performance and conducting audits. We found that all five states have independent units, within their executive level of government, that oversee performance monitoring and/or conduct performance audits.

The types of entities conducting performance audits varied among the five states. They included state auditor offices, an administrative board, a specialized audit team, and a legislative committee that primarily consists of research analysts, rather than auditors. One state has developed statewide strategic benchmarks and extensive performance measure guidelines that include detailed reporting, monitoring, and review requirements. Two other states perform regular sunset reviews of their agencies or programs to determine if they should continue. Furthermore, one state created a management advisory group that provides consulting services to its agencies in areas such as strategic planning, developing performance measures and statistical sampling and analysis. Details of these states’ oversight, monitoring, and audit functions are provided at Appendix X.

We also reviewed the results from a recent survey of 210 state government auditors that perform various audit functions within 37 states. The survey was sponsored by the Institute of Internal Auditors (IIA) and was conducted jointly by the IIA and two other national audit organizations. Although auditors responsibilities most often included compliance and internal control audits, some performance/operational audits were conducted by 80 percent of the internal auditors surveyed.

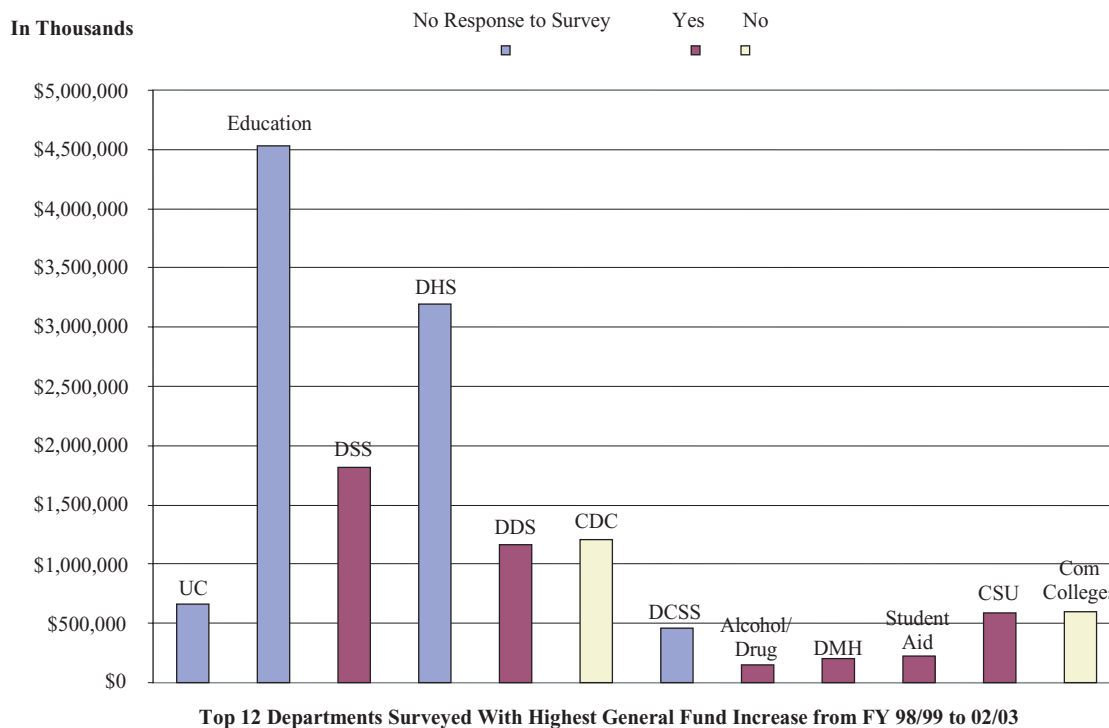
Conclusion

Similar to other states and the federal government, then-Governor Wilson and the Legislature attempted to reform California’s budget and management practices with the Strategic Planning and Review Act in 1994. DOF had responsibility for direction and oversight. However, neither DOF nor any other control agency has attempted to monitor or track statewide strategic planning efforts since 1996. In addition to the statewide strategic planning, the state implemented a Performance Budget Pilot Project that involved four agencies. However, the pilot project was not supported past its early implementation and subsequently failed because resources and guidance were not provided.

California’s attempts at strategic planning and experimentation with performance budgeting have shown some positive results. As indicated above, most agencies we surveyed indicated

that they use strategic planning to some extent and have developed performance measures in the process. Also, many agencies have integrated performance into their budgeting processes and identified positive results, all using existing resources. However, some agencies with the highest increase in General Fund expenditure did not always use strategic plans or performance measures, as shown in Exhibit K.

Exhibit K
Departments Using Strategic Plans and Performance Measures



Training will be one crucial element in making California successful in implementing statewide strategic planning and performance budgeting. As indicated above, although over half of the surveyed agencies use internal staff to prepare their strategic plans, many hired external consultants to assist them. Neither of these scenarios ensures consistency among the state's entities. In addition to training, other key obstacles include resources for adequate staffing and for new or enhanced existing systems to track, measure, and report data. Success will also depend on continuous support from the executive levels of government. Furthermore, the state needs to provide better oversight and monitoring of its performance related activities. Specifically, the state should provide agencies with detailed training and guidance and ensure that agencies are complying with strategic planning, performance measuring and performance budgeting requirements.



The Audit Community

California state government does not take accountability lightly. What other conclusion could one draw knowing that approximately 60 state agencies employ 4,000 auditors, evaluators and examiners? Moreover, external auditors representing the federal government and the public interest perform audits of specific systems, programs, grants and recipients of state funds in departments statewide. As a case in point, between federal and state, external and internal, 21 different audit teams have reviewed Department of Health Services programs and activities this fiscal year.

As noted above, the state's internal auditors provide their departments valuable recommendations that are usually implemented. Additionally, OSAE, SCO and BSA auditors serve the Executive Branch, the Controller and the Legislature in fulfilling their responsibilities for monitoring and oversight of the state's interests. The state's regulatory and tax auditors carry out their program/function specific audits to maximize revenues, monitor expenditures, and verify compliance as their resources allow. In total, the complementary nature of the audit specialties and the breadth of scope the auditors cover provide reasonable assurance that the state's operations are carried out in accordance with management's directives and intent. However, the state's audit function can and should improve.

In reviewing the varying classifications and requirements placed on the auditors, we determined that many classifications require similar preparation to perform similar duties. Typically, these classifications require a college degree (or equivalent) in a financial related field, with a specific number of accounting/business units as a basic entry-level requirement. In addition, entry-level staff must be able to obtain relevant documentation, analyze data, develop workpapers and present results, all under close supervision. These entry-level requirements help assure a professional and knowledgeable workforce. However, given the similarity of entry-level requirements among the different departments and classifications, the question must be raised as to whether so many different classifications are necessary or useful.

The foregoing notwithstanding, one area that should have a separate classification for all audit organizations to use is the Information Technology auditor. The California Public Employees' Retirement System and BSA each maintains a specialist classification for IT auditors, but the use of these classifications is restricted to those organizations. Given the reliance we place on our automated systems and the separate, identifiable skills necessary for proficiency in this audit area, this lapse should be addressed.

Again, as discussed in the Financial Review section above, guidance and coordination of the state's audit function is minimal and not strictly enforced. Without a strong, coordinated effort involving auditors statewide, we believe the audit work completed by the state's internal auditors may be inefficient and likely results in the inconsistent application of audit standards. To address the need for guidance and coordination, we propose that any reorganization of

state government include agency-level audit offices. This would help ensure a consistent application of audit standards, comparable audit results among and between the agencies and a point of responsibility to assess risk throughout the agency. In addition, these audit offices should be staffed with auditors versed in performance auditing and in IT and security reviews.

As mentioned above, the review was performed in accordance with GAGAS applicable to attestation engagements. These standards require the auditor to report on subject matter that is the responsibility of another party. In this case, that subject matter is the agreed-upon procedures set out in the audit proposal to CPR. We note that in accordance with GAGAS, the CPR auditors are organizationally independent from the issues included in the agreed-upon procedures only to the extent that these issues and report are used by CPR and California Executive Branch management. That is, the CPR audit team members are all employees of the departments and organizations that are subject to the engagement. This report is not intended for and should not be used by anyone other than the specified party. However, its distribution is not restricted for any other reason.

Respectfully Submitted,



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Audit Report Appendices

Table of Contents

Appendix I:	Methodology for and Discussion of the “Line-by-Line” Audit	87
Appendix II:	Department/Activity General Fund Expenditures Amount and Percent Change FY 1998–1999 to FY 2002–2003	91
Appendix III:	A Departmental Case Study: California Department of Corrections Increases in General Fund Expenditures from FY 1998–1999 to FY 2002–2003	97
Appendix IV:	Encumbrance Increases: June 30, 2000 to June 30, 2001	101
Appendix V:	Encumbrance Balances at June 30, 2003.....	103
Appendix VI:	Existing Financial Systems Attributes	105
Appendix VII:	Top Concerns of Departments Sampled About Financial Management Systems	107
Appendix VIII:	State of California Enterprise Financial Systems Summary of Lessons Learned	109
Appendix IX:	Other Public Sector Enterprise Financial Systems Summary of Lessons Learned	111
Appendix X:	Other States’ Oversight and Monitoring of Performance	113



Appendix I

Methodology for and Discussion of the “Line-by-Line” Audit

At the outset of the California Performance Review (CPR), the Audit Team was added to the group identified in the Governor’s Executive Order to complete what was referred to as a “line-by-line” audit. We set out to define that task, to determine how to approach it, and finally to complete the audit work necessary to report it. This report provides a roadmap for the state’s “line-by-line” audit through its ongoing monitoring and control functions. Moreover, through proposed changes in budgeting, fiscal systems, strategic planning and resource reorganization, the state will ensure that the “line-by-line” concept is not treated as a one-time panacea, but rather an iterative effort to promote efficient and effective government as core values.

The Audit Team’s approach to a “line-by-line” audit is one of synthesis of the work performed by the audit and control entities named below and through our verification and validation of their inputs in the context of an acquisition model. That is, we have reviewed and validated the accuracy and completeness of the state’s existing entities, systems, and structures from the Budget, Financial and Performance perspectives. Moreover, we have preliminarily assessed the extent and deployment of the state’s existing auditing resources. We have focused on opportunities for improved coordination and the use of existing and updated resources to ensure the state’s control framework promotes effective operations. California deserves no less.

A Virtual “Line-By-Line” Audit

The Department of Finance (DOF) develops and analyzes the Governor’s Budget in consort and consultation with the state’s agency and department budget experts. The Governor’s Budget proposal is transmitted to the Legislative Analyst’s Office (LAO) for critical review and comment prior to its approval by the Legislature and authorization by the Governor. This development and analysis constitute the first steps in the “line-by-line” audit, as both DOF and LAO staff provide intensive review and authoritative discussion as to the budget’s highlights and potential pitfalls.

The State Controller’s Office (SCO) maintains the official accounting records, recording all receipts and expenditures of funds as approved in the budget and produces the Consolidated Annual Financial Report (CAFR). This document represents the rolled-up results of state operations in accordance with generally accepted accounting principles, and is the subject matter for the Bureau of State Audits (BSA) annual Single Audit report, that is the audit of the state’s consolidated books. SCO’s financial reporting structure accurately tracks state revenues and expenditures on a cash basis (that is, amounts deposited and checks drawn) throughout

the year and adjusts at year-end for accruals in accordance with generally accepted accounting principles (GAAP). The amounts reported are accurate to the extent that the systems that develop them and the reported transactions that support them are in turn accurate. On a wide-scale basis, BSA's auditors assigned to the Single Audit spend their time assessing the underlying validity of the CAFR. They conclude as to the report's material accuracy and report internal control findings that might affect the accuracy of the statements. BSA has presented an unqualified (clean) opinion on the state's financial statements for all years since and including 1998–1999 with extra notations in the June 30, 1999 report regarding Year 2000 issues, in the June 30, 2001 report regarding energy contracts and lawsuits, and in the June 30, 2003 report regarding the exclusion of the State Compensation Insurance Fund from the overall audit. How reliable is BSA's work? BSA received a clean opinion on its Peer Review—performed by the National State Auditors Association and reported on October 2, 2002 (a peer review is required every three years). The adequacy of the financial systems and their outputs, and the report on them by independent auditors represent further evidence for the “line-by-line” audit.

The next component of the “line-by-line” comes from the answers to the following: Are all revenues that should be received actually received, and are expenditures going for their intended purposes? The revenue side of the equation is addressed by the state's collection entities: the Franchise Tax Board, Board of Equalization, Departments of Motor Vehicles and Insurance, and other fee and tax agencies. Their efforts are recorded with SCO and monitored by their internal fiscal staff as well as by DOF's revenue unit. The expenditure question requires another caveat before it can be addressed in the audit context: complete and accurate assessments of expenditures can only be made if the intended purposes have been clearly stated and measurement systems and data are available. So, to determine the effectiveness and efficiency of expenditures and the completeness of estimated/expected revenues, a performance measurement structure is necessary. This report discusses that structure and its future application.

The final piece of the “line-by-line” audit is the assessment of program necessity and effectiveness. This function rests in part with the state's umbrella of auditors, evaluators, examiners and investigators. On a day-to-day basis, the 2,000+ (other than FTB and BOE tax auditors) auditor community, representing 56 different state entities, provides its input on state operations continuing effectiveness through program and service provider monitoring and oversight. Their efforts are documented by the reports and recommendations they make, and by the corrective actions that follow. Concurrent to this audit, CPR is presenting its report. Through its issue papers, CPR's functional and cross-cutting teams have performed just the kind of assessments referenced above. The work of these 250+ team members constitutes the detail subject of the current “line-by-line” audit; that is, it questions whether the programs discussed in the individual issue papers have a continuing basis for existence, are provided the appropriate level of resources and are monitored and assessed recurrently for performance as defined by the enabling legislation, regulation, or directives.



With all these components operating in unison, the state would be reasonably assured that its operations met its objectives and that its resources were applied appropriately. However, we believe that in spite of the best intended efforts of the parts, the whole is not coordinated and the results are not effective. The structural weaknesses and deficiencies reported in the media and by various observers have given rise to the notion and expectation that a one-time “line-by-line” audit may cure the state’s ills. But we reject that notion and propose that only through continuing efforts and regular assessments, evaluations, review and audit can the state achieve its objectives effectively and efficiently.



Appendix II

Appendix II illustrates total state General Fund expenditures as presented in the State Controller's Office, Budgetary/Legal Basis Annual Report for FY 1998–1999 and 2002–2003. The schedule presents the change in General Fund expenditures in descending order by department or function area. As illustrated, 98 departments/functions received General Fund increases, 69 incurred no change in the General Fund funding, and 53 received less General Fund funding.

Number	Department/Function	General Fund Expenditures		Change From FY 1998–99 to 2002–03		
		FY 1998–99	FY 2002–03	Amount	Percent Increase	Percent of Total Increase
1	Department of Education	\$22,297,963	\$26,438,638	\$4,140,675	18.6%	20.4%
2	Tax Relief	450,213	4,446,940	3,996,727	887.7%	19.7%
3	Department of Health Services	8,029,428	11,197,109	3,167,681	39.5%	15.6%
4	Department of Social Services	6,334,497	8,146,804	1,812,307	28.6%	8.9%
5	Department of Developmental Services	672,285	1,879,679	1,207,394	179.6%	5.9%
6	Department of Corrections	4,283,111	5,188,903	905,792	21.1%	4.5%
7	Contributions to Teacher's Retirement System	292,931	975,522	682,591	233.0%	3.4%
8	University of California	2,518,649	3,150,011	631,362	25.1%	3.1%
9	California State University	2,107,022	2,705,469	598,447	28.4%	2.9%
10	Reserve for Liquidation of Encumbrances	-112,173	454,130	566,303	504.8%	2.8%
11	Board of Governors of the California Community Colleges	2,185,445	2,652,990	467,545	21.4%	2.3%
12	Department of Child Support Services	0	459,703	459,703	100.0%	2.3%
13	Department of the Youth Authority	20,443	360,080	339,637	1661.4%	1.7%
14	Payment of Interest on General Fund Loans	47,729	338,670	290,941	609.6%	1.4%
15	Health and Dental Benefits for Annuitants	309,707	560,999	251,292	81.1%	1.2%
16	California Student Aid Commission	343,409	569,020	225,611	65.7%	1.1%
17	Local Government Financing	154,703	355,254	200,551	129.6%	1.0%
18	Department of Mental Health	654,963	849,954	194,991	29.8%	1.0%
19	Legislature	15,839	198,235	182,396	1151.6%	0.9%
20	General Fund Credits from Special Funds	-146,611	0	146,611	100.0%	0.7%
21	Department of Alcohol and Drug Programs	90,170	235,213	145,043	160.9%	0.7%
22	Scholarshare Investment Board	0	119,357	119,357	100.0%	0.6%
23	Federal Immigration Funding-Incarceration	-183,937	-66,182	117,755	64.0%	0.6%
24	State Trial Court Funding	976,225	1,092,413	116,188	11.9%	0.6%
25	Department of Forestry and Fire Protection	347,573	436,483	88,910	25.6%	0.4%
26	Judicial	204,512	289,266	84,754	41.4%	0.4%
27	Board of Corrections	27,579	78,718	51,139	185.4%	0.3%
28	Franchise Tax Board	360,489	409,823	49,334	13.7%	0.2%
29	Department of Justice	270,255	308,344	38,089	14.1%	0.2%
30	Department of Personnel Administration	5,418	43,159	37,741	696.6%	0.2%

Number	Department/Function	General Fund Expenditures		Change From FY 1998–99 to 2002–03		
		FY 1998–99	FY 2002–03	Amount	Percent Increase	Percent of Total Increase
31	Shared Revenues	73	37,128	37,055	50760.3%	0.2%
32	Department of Water Resources	165,115	195,500	30,385	18.4%	0.1%
33	State Water Resources Control Board	41,620	71,858	30,238	72.7%	0.1%
34	Department of Veterans Affairs	42,408	72,218	29,810	70.3%	0.1%
35	Contributions to Judges' Retirement System	86,908	113,802	26,894	30.9%	0.1%
36	Department of Fish and Game	22,072	48,158	26,086	118.2%	0.1%
37	Department of Parks and Recreation	108,516	132,343	23,827	22.0%	0.1%
38	Department of Food and Agriculture	78,195	101,489	23,294	29.8%	0.1%
39	Emergency Medical Services Authority	5,506	27,715	22,209	403.4%	0.1%
40	Office of Criminal Justice Planning	41,827	63,780	21,953	52.5%	0.1%
41	Legislative Counsel Bureau	59,702	76,930	17,228	28.9%	0.1%
42	Department of Rehabilitation	131,872	148,208	16,336	12.4%	0.1%
43	State Board of Equalization	180,323	196,047	15,724	8.7%	0.1%
44	Board of Prison Terms	14,741	29,731	14,990	101.7%	0.1%
45	Military Department	25,464	39,490	14,026	55.1%	0.1%
46	California Conservation Corps	32,359	45,689	13,330	41.2%	0.1%
47	Bureau of State Audits	-129	10,921	11,050	8565.9%	0.1%
48	Commission on Teacher Credentialing	26,853	37,063	10,210	38.0%	0.1%
49	Managed Risk Medical Insurance Board	17,803	26,258	8,455	47.5%	0.0%
50	Department of Industrial Relations	141,462	149,695	8,233	5.8%	0.0%
51	State Controller	61,522	68,825	7,303	11.9%	0.0%
52	Office of the Inspector General	1,821	8,780	6,959	382.2%	0.0%
53	Department of Finance	23,068	29,823	6,755	29.3%	0.0%
54	Department of Conservation	15,724	21,643	5,919	37.6%	0.0%
55	Office of Environmental Health Hazard Assessment	6,104	10,888	4,784	78.4%	0.0%
56	California Coastal Commission	7,271	10,715	3,444	47.4%	0.0%
57	Department of Community Services and Development	3,050	6,442	3,392	111.2%	0.0%
58	Office of Planning and Research	15,698	19,027	3,329	21.2%	0.0%
59	Secretary for California Health and Human Services Agency	1,051	3,219	2,168	206.3%	0.0%
60	Correctional Peace Officer Standards and Training	0	2,102	2,102	100.0%	0.0%
61	California Science Center	10,800	12,878	2,078	19.2%	0.0%
62	Department of Toxic Substances Control	29,495	31,299	1,804	6.1%	0.0%
63	San Francisco Bay Conservation & Development Commission	1,786	3,465	1,679	94.0%	0.0%
64	California State Library	72,030	73,273	1,243	1.7%	0.0%
65	Department of Fair Employment and Housing	15,021	16,200	1,179	7.8%	0.0%
66	Hastings College of the Law	13,244	14,422	1,178	8.9%	0.0%
67	Fair Political Practices Commission	5,321	6,474	1,153	21.7%	0.0%
68	Office of the Lieutenant Governor	1,376	2,511	1,135	82.5%	0.0%
69	Unallocated Capital Outlay	744	1,739	995	133.7%	0.0%
70	Milton Marks "Little Hoover" Commission	0	832	832	100.0%	0.0%



<u>General Fund Expenditures</u>				<u>Change From FY 1998–99 to 2002–03</u>		
<u>Number</u>	<u>Department/Function</u>	<u>FY 1998–99</u>	<u>FY 2002–03</u>	<u>Amount</u>	<u>Percent Increase</u>	<u>Percent of Total Increase</u>
71	State Treasurer	4,672	5,452	780	16.7%	0.0%
72	Agricultural Labor Relations Board	3,887	4,662	775	19.9%	0.0%
73	Commission on Judicial Performance	2,987	3,683	696	23.3%	0.0%
74	Consumer Affairs-Boards, Bureaus, Programs, Divisions	0	656	656	100.0%	0.0%
75	Interest Payments to the Federal Government	4,515	5,050	535	11.8%	0.0%
76	Governor's Office	5,475	5,946	471	8.6%	0.0%
77	Federal Levy of State Funds	-375	0	375	100.0%	0.0%
78	Office of the Inspector General for Veterans Affairs	0	371	371	100.0%	0.0%
79	State Lands Commission	10,048	10,406	358	3.6%	0.0%
80	Commission on State Mandates	1,155	1,462	307	26.6%	0.0%
81	Child Development Policy Advisory Committee	0	298	298	100.0%	0.0%
82	State Personnel Board	6,174	6,468	294	4.8%	0.0%
83	Seismic Safety Commission	601	878	277	46.1%	0.0%
84	Payment to Counties for Costs of Homicide Trials	5,328	5,508	180	3.4%	0.0%
85	CA State Summer School for the Arts	723	888	165	22.8%	0.0%
86	Fair Employment and Housing Commission	1,086	1,196	110	10.1%	0.0%
87	Department of Motor Vehicles	1,514	1,598	84	5.5%	0.0%
88	Secretary for State and Consumer Services	688	767	79	11.5%	0.0%
89	CA Integrated Waste Management Board	0	46	46	100.0%	0.0%
90	Commission on the Status of Women	394	439	45	11.4%	0.0%
91	Native American Heritage Commission	286	330	44	15.4%	0.0%
92	California Law Revision Commission	590	634	44	7.5%	0.0%
93	Education Audit Appeals Panel	0	41	41	100.0%	0.0%
94	Office of Administrative Law	2,322	2,344	22	0.9%	0.0%
95	Secretary for Resources	4,371	4,391	20	0.5%	0.0%
96	Public Employment Relations Board	4,270	4,282	12	0.3%	0.0%
97	Commission on Uniform State Laws	126	138	12	9.5%	0.0%
98	California Citizens Compensation Commission	1	8	7	700.0%	0.0%
99	Secretary for Business, Transportation, and Housing	0	0	0	0.0%	0.0%
100	Department of Alcoholic Beverage Control	0	0	0	0.0%	0.0%
101	Alcoholic Beverage Control Appeals Board	0	0	0	0.0%	0.0%
102	Department of Financial Institutions	0	0	0	0.0%	0.0%
103	Department of Corporations	0	0	0	0.0%	0.0%
104	California Housing Finance Agency	0	0	0	0.0%	0.0%
105	Office of Real Estate Appraisers	0	0	0	0.0%	0.0%
106	Department of Real Estate	0	0	0	0.0%	0.0%
107	Department of Managed Health Care	0	0	0	0.0%	0.0%
108	Special Transportation Programs	0	0	0	0.0%	0.0%
109	High-Speed Rail Authority	0	0	0	0.0%	0.0%
110	Office of Traffic Safety	0	0	0	0.0%	0.0%
111	Department of the California Highway Patrol	0	0	0	0.0%	0.0%
112	Stephen P. Teale Data Center	0	0	0	0.0%	0.0%
113	Statewide Distributed Costs	0	0	0	0.0%	0.0%

Number	Department/Function	General Fund Expenditures		Change From FY 1998–99 to 2002–03		
		FY 1998–99	FY 2002–03	Amount	Percent Increase	Percent of Total Increase
114	Department of Boating & Waterways	0	0	0	0.0%	0.0%
115	Santa Monica Mountains Conservancy	0	0	0	0.0%	0.0%
116	San Gabriel and Lower LA Rivers and Mountain Conservancy	0	0	0	0.0%	0.0%
117	San Joaquin River Conservancy	0	0	0	0.0%	0.0%
118	Baldwin Hills Conservancy	0	0	0	0.0%	0.0%
119	Delta Protection Commission	0	0	0	0.0%	0.0%
120	San Diego River Conservancy	0	0	0	0.0%	0.0%
121	Coachella Valley Mountains Conservancy	0	0	0	0.0%	0.0%
122	California Bay-Delta Authority	0	0	0	0.0%	0.0%
123	Renewable Resources Investment Program	0	0	0	0.0%	0.0%
124	General Obligation Bonds-Resources	0	0	0	0.0%	0.0%
125	General Obligation Bonds-Environmental State Operations	0	0	0	0.0%	0.0%
126	State Council on Developmental Disabilities	0	0	0	0.0%	0.0%
127	Area Boards on Developmental Disabilities	0	0	0	0.0%	0.0%
128	Health and Human Services Agency Data Center	0	0	0	0.0%	0.0%
129	Commission on Aging	0	0	0	0.0%	0.0%
130	California Children and Families Commission	0	0	0	0.0%	0.0%
131	Department of Independent Living Council	0	0	0	0.0%	0.0%
132	State-Local Realignment	0	0	0	0.0%	0.0%
133	Miscellaneous Adjustments-H&HS	0	0	0	0.0%	0.0%
134	General Obligation Bonds-H&HS	0	0	0	0.0%	0.0%
135	General Obligation Bonds-YAC	0	0	0	0.0%	0.0%
136	Office of the Secretary for Education	0	0	0	0.0%	0.0%
137	Retirement Costs for Community Colleges	0	0	0	0.0%	0.0%
138	CA Occupational Info Coordinating Commission	0	0	0	0.0%	0.0%
139	General Obligation Bonds-Higher Education-CC	0	0	0	0.0%	0.0%
140	Retirement Costs-Higher Education-CC	0	0	0	0.0%	0.0%
141	General Obligation Bonds K–12	0	0	0	0.0%	0.0%
142	General Obligation Bonds-Higher Education	0	0	0	0.0%	0.0%
143	California Workforce Investment Board	0	0	0	0.0%	0.0%
144	Commission on Peace Officer Standards and Training	0	0	0	0.0%	0.0%
145	Board of Chiropractic Examiners	0	0	0	0.0%	0.0%
146	Board of Osteopathic Medical Board of California	0	0	0	0.0%	0.0%
147	Board of Pilot Commissioners for the Bays of SF, San Pablo & Suisun	0	0	0	0.0%	0.0%
148	California Horse Racing Board	0	0	0	0.0%	0.0%
149	Political Reform Act of 1974	0	0	0	0.0%	0.0%
150	CA Consumer Power & Conservation Financing Authority	0	0	0	0.0%	0.0%
151	Veterans Memorial Commission	0	0	0	0.0%	0.0%
152	General Obligation Bonds-Gen. Govt.	0	0	0	0.0%	0.0%
153	Lease-Revenue Notes and Bonds	0	0	0	0.0%	0.0%



<u>General Fund Expenditures</u>				<u>Change From FY 1998–99 to 2002–03</u>		
<u>Number</u>	<u>Department/Function</u>	<u>FY 1998–99</u>	<u>FY 2002–03</u>	<u>Amount</u>	<u>Percent Increase</u>	<u>Percent of Total Increase</u>
154	Augmentation for Contingencies or Emergencies	0	0	0	0.0%	0.0%
155	Capital Outlay Planning and Studies Funding	0	0	0	0.0%	0.0%
156	Statewide ADA Funding	0	0	0	0.0%	0.0%
157	Health Insurance Portability & Accountability Act Compliance	0	0	0	0.0%	0.0%
158	Utilities Costs	0	0	0	0.0%	0.0%
159	Department of Justice Attorney Fees	0	0	0	0.0%	0.0%
160	Postage Rate Increase	0	0	0	0.0%	0.0%
161	Brown v. US. Dept. HHS	0	0	0	0.0%	0.0%
162	Statewide Proposition 98 Reconciliation	0	0	0	0.0%	0.0%
163	PERS General Fund Payment	0	0	0	0.0%	0.0%
164	Various Departments	0	0	0	0.0%	0.0%
165	Vietnam Veterans Memorial Commission	0	0	0	0.0%	0.0%
166	Adjustment to Reconcile to Controller	0	0	0	0.0%	0.0%
167	Statewide Savings	0	0	0	0.0%	0.0%
168	California Medical Assistance Commission	1,054	1,052	-2	-0.2%	0.0%
169	Electricity Oversight Board	0	-10	-10	-100.0%	0.0%
170	Secretary for Labor and Workforce Development Agency	0	-14	-14	-100.0%	0.0%
171	Colorado River Board	188	166	-22	-11.7%	0.0%
172	Governor's Portrait	25	0	-25	-100.0%	0.0%
173	State Athletic Commission	773	683	-90	-11.6%	0.0%
174	State Public Defender	11,024	10,924	-100	-0.9%	0.0%
175	Youthful Offender Parole Board	3,314	3,152	-162	-4.9%	0.0%
176	California Afro-American Museum	2,164	1,975	-189	-8.7%	0.0%
177	Employment Development Department	23,050	22,861	-189	-0.8%	0.0%
178	Governors Advisory Committee, Child Development Program	271	0	-271	-100.0%	0.0%
179	Commission for Academic Content and Performance Standards	415	0	-415	-100.0%	0.0%
180	Commission on Local Governance for 21st Century	452	0	-452	-100.0%	0.0%
181	Contributions to the Legislator's Retirement System	578	0	-578	-100.0%	0.0%
182	Department of Transportation	600	0	-600	-100.0%	0.0%
183	Governor Elect and Outgoing Governor	650	0	-650	-100.0%	0.0%
184	Comm. On State Govt. Organization and Economy	687	0	-687	-100.0%	0.0%
185	Department of Insurance	741	0	-741	-100.0%	0.0%
186	Secretary for Youth and Adult Correctional Agency	1,666	878	-788	-47.3%	0.0%
187	Secretary for Environmental Protection	3,396	2,519	-877	-25.8%	0.0%
188	Augmentation for Employee Compensation	894	0	-894	-100.0%	0.0%
189	CA Postsecondary Education Commission	3,051	2,127	-924	-30.3%	0.0%
190	Memberships in Interstate Organizations	2,618	931	-1,687	-64.4%	0.0%
191	Special Resources Programs	2,020	200	-1,820	-90.1%	0.0%
192	CA Victim Compensation and Government Claims Board	3,342	1,355	-1,987	-59.5%	0.0%

Number	Department/Function	General Fund Expenditures		Change From FY 1998–99 to 2002–03		
		FY 1998–99	FY 2002–03	Amount	Percent Increase	Percent of Total Increase
193	California Transportation Commission	2,000	0	–2,000	–100.0%	0.0%
194	Worker’s Compensation Benefits	5,968	3,917	–2,051	–34.4%	0.0%
195	Energy Resources Conservation & Development Commission	0	–2,092	–2,092	–100.0%	0.0%
196	Habeas Resource Center	3,165	0	–3,165	–100.0%	0.0%
197	Secretary of State	33,163	29,794	–3,369	–10.2%	0.0%
198	Office of Statewide Health Planning and Development	7,899	3,981	–3,918	–49.6%	0.0%
199	Judgments, Settlements, and Tort Liability Claims	5,339	1,361	–3,978	–74.5%	0.0%
200	Department of Pesticide Regulation	17,154	12,721	–4,433	–25.8%	0.0%
201	Department of Aging	43,361	38,873	–4,488	–10.4%	0.0%
202	Department of Housing & Community Development	20,927	16,280	–4,647	–22.2%	0.0%
203	California Tahoe Conservancy	8,089	2,706	–5,383	–66.5%	0.0%
204	Payment of Interest on PMIA Loans	8,975	2,828	–6,147	–68.5%	0.0%
205	Department of General Services	25,364	16,975	–8,389	–33.1%	0.0%
206	School Facilities Aid Program	25,736	13,953	–11,783	–45.8%	–0.1%
207	California Arts Council	34,192	19,974	–14,218	–41.6%	–0.1%
208	State Coastal Conservancy	16,543	1,429	–15,114	–91.4%	–0.1%
209	Department of Information Technology	16,593	0	–16,593	–100.0%	–0.1%
210	General Fund Credits from Federal Funds	–32,791	–50,313	–17,522	–53.4%	–0.1%
211	State Air Resources Board	50,355	23,598	–26,757	–53.1%	–0.1%
212	Public Utilities Commission	28,000	8	–27,992	–100.0%	–0.1%
213	Miscellaneous	0	–40,941	–40,941	100.0%	–0.2%
214	Office of Emergency Services	100,750	54,111	–46,639	–46.3%	–0.2%
215	Technology, Trade, and Commerce Agency	107,265	45,349	–61,916	–57.7%	–0.3%
216	Wildlife Conservation Board	131,467	12,091	–119,376	–90.8%	–0.6%
217	Other Statewide Expenditures	161,613	0	–161,613	–100.0%	–0.8%
218	General Obligation Bonds and Commercial Paper	1,926,694	1,720,994	–205,700	–10.7%	–1.0%
219	Statewide General Administrative Expenditures (Pro Rata)	0	–325,527	–325,527	–100.0%	–1.6%
220	Equity Claims–Board of Control & Settlements and Judgments by DOJ	<u>334,598</u>	<u>2,182</u>	<u>–332,416</u>	<u>–99.3%</u>	<u>–1.6%</u>
	Totals	<u>\$57,271,883</u>	<u>\$77,564,277</u>	<u>\$20,292,394</u>	<u>35.4%</u>	<u>100.0%</u>
			<u>Number of Departments</u>	<u>Amount</u>	<u>Percent of Total</u>	
Net General Fund Increase From FY 1998–99 to FY 2002–03			<u>98</u>	<u>\$21,784,735</u>	<u>107.4%</u>	
Net General Fund Decrease From FY 1998–99 to FY 2002–03			<u>53</u>	<u>–\$1,492,341</u>	<u>–7.4%</u>	
No General Fund Change From FY 1998–99 to FY 2002–03			<u>69</u>	<u>\$0</u>	<u>0.0%</u>	
Totals			<u>220</u>	<u>\$20,292,394</u>	<u>100.0%</u>	



Appendix III

A Departmental Case Study: California Department of Corrections Increases in General Fund Expenditures from FY 1998–1999 to 2002–2003

CDC General Fund expenditures increased by \$1.2 billion (30.1 percent) from FY 1998–1999 to 2002–2003. The majority of the increase occurred in the following areas:

• Salaries and Wages	\$ 472,391
• Consultant and Professional Services-External	206,065
• Retirement	159,046
• Other Items of Expense	108,912
• Overtime	<u>86,705</u>
Totals	<u>\$1,033,119</u>

These categories of expenditure account for 85.9 percent of the total CDC increase. The categorical amounts are discussed and analyzed below.

Salaries and Wages

CDC's personnel years (PY) increased by 2,804.8 (6.7 percent), from 41,684.7 in FY 1998–1999 to 44,453.5 in FY 2002–2003. The PY increases contributed to the increased salaries and wages, but several pay raises granted to custody employees (5 percent in FY 1998–1999 and 4 percent in FY 1999–2000 and 2000–2001) and non-custody employees (4 percent in FY 1999–2000 and 2000–2001) had a greater impact. As illustrated in Exhibit A-2-1, \$342.6 million (72.5 percent) of the increases in salaries and wages occurred in the Institutions Program.

Exhibit A-2-1
Salaries and Wages Increases by Program
(dollars in thousands)

<u>Program</u>	<u>1998–99 Expenditures</u>	<u>2002–03 Expenditures</u>	<u>Dollar Increase</u>	<u>Percent Increase</u>
Institutions	\$1,477,461	\$1,820,024	\$342,563	23.2%
Health Care Services	204,799	272,605	67,806	33.1%
Community Correctional	135,162	185,075	49,913	36.9%
Administration	<u>57,350</u>	<u>69,459</u>	<u>12,109</u>	21.1%
Totals	<u>\$1,874,772</u>	<u>\$2,347,163</u>	<u>\$472,391</u>	25.2%

Source: California Department of Corrections

Consultant/Professional Services–External

Consultant/Professional Services-External are costs associated with contractors providing goods and services. As illustrated in Exhibit A-2-2, from FY 1998–1999 to 2002–2003, expenditures for consultants and professional services increased by \$206.1 million (69.3 percent), with the growth almost divided evenly between the Institutions Program (\$146.9 million) and Health Care Services Program (\$141.4 million). The Community Correctional Program was reduced significantly during this period.

Exhibit A-2-2
Consultant/Professional Services
(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percent Increase
Institutions	\$36,534	\$183,391	\$146,857	402.0%
Health Care Services	98,725	240,078	141,353	143.2%
Community Correctional	156,490	75,550	–80,940	–51.7%
Administration	<u>5,471</u>	<u>4,266</u>	<u>–1,205</u>	–22.0%
Total	<u>\$297,220</u>	<u>\$503,285</u>	<u>\$206,065</u>	69.3%

Source: California Department of Corrections

The increase in the Institutions Program is primarily due to a program change of moving the Community Correctional Facility contracts from the Community Services Program to the Institutions Program in FY 2001–2002.

The Health Care Services Program provides physical and mental health care to the inmate population statewide consistent with adopted standards for quality and scope of services within a custodial environment. The Health Care Services Program operates various types of medical facilities at several institutions statewide, including four licensed hospitals, a skilled nursing facility and other specialized medical units and clinics. Because CDC's facilities cannot meet the overall demand for necessary health care services, CDC contracts locally with external medical service providers such as hospitals, specialty care physicians and laboratories.

Consultant and professional service contracts in the Health Care Services Program increased by \$141.4 million (143.2 percent) from FY 1998–1999 to 2002–2003. The major contributing factors for this increase were pharmaceuticals and medical services contracts. A BSA report issued in April 2004 identified internal control weaknesses in CDC's contracting processes for medical services.



Retirement

As illustrated in Exhibit A-2-3, retirement costs increased by \$159.1 million (85.1 percent) from FY 1998–1999 to 2002–2003.

Exhibit A-2-3

Retirement

(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Increase	Percent Increase
Institutions	\$152,184	\$277,618	\$125,434	82.4%
Health Care Services	17,701	38,433	20,732	117.1%
Community Correctional	13,378	25,642	12,264	91.7%
Administration	3,565	4,181	616	17.3%
Totals	<u>\$186,828</u>	<u>\$345,874</u>	<u>\$159,046</u>	85.1%

Source: California Department of Corrections

Note: Totals may not foot and cross-foot due to rounding.

The downturn of the stock market in 2000–2001 and enhanced retirement benefits are responsible for the retirement costs increase. The state share of retirement contribution rates established for peace officers increased from 9.6 percent in FY 1998–1999 to 13.9 percent in FY 2002–2003. For employee classifications identified as “Safety,” retirement contribution rates increased from 9.4 percent in FY 1998–1999 to 17.1 percent in FY 2002–2003.

Other Items of Expense

As illustrated in Exhibit A-2-4, \$78.2 million (71.8 percent) of the total increase in “Other Items of Expense” for the period from FY 1998–99 through 2002–03 occurred in the Health Care Services Program. This program’s Other Items of Expense increased from \$60.8 million in FY 1998–1999 to \$139 million in FY 2002–03. Increased chemical, drug, medical and laboratory costs make up to 97 percent of the increases.

Exhibit A-2-4

Other Items of Expense

(dollars in thousands)

Program	1998–99 Expenditures	2002–03 Expenditures	Dollar Inc./Dec.	Percent Inc./Dec.
Institutions	\$252,429	\$271,548	\$19,119	7.6%
Health Care Services	60,764	138,972	78,208	128.7%
Community Correctional	19,414	31,433	12,019	61.9%
Administration	653	219	– 434	– 66.5%
Total	<u>\$333,260</u>	<u>\$442,172</u>	<u>\$108,912</u>	32.7%

Source: California Department of Corrections

Note: Totals may not foot and cross-foot due to rounding.

Overtime

Overtime costs increased by \$86.7 million (55 percent) from \$157.6 million in FY 1998–1999 to \$244.3 million in FY 2002–2003. As illustrated in Exhibit A-2-5, \$81.5 million (94 percent) of the increase was incurred in the Institutions Program. This condition is further analyzed below.

Overtime Exhibit A-2-5

(dollars in thousands)

<u>Program</u>	<u>1998–99 Expenditures</u>	<u>2002–03 Expenditures</u>	<u>Dollar Inc./Dec.</u>	<u>Percent Inc./Dec.</u>
Institutions	\$132,137	\$213,605	\$81,468	61.7%
Health Care Services	14,906	24,097	9,191	61.7%
Community Corrections	8,092	5,670	–2,422	–29.9%
Administration	<u>2,430</u>	<u>898</u>	<u>–1,532</u>	–63.0%
Total	<u>\$157,565</u>	<u>\$244,270</u>	<u>\$86,705</u>	55.0%

Source: California Department of Corrections

Note: Totals may not foot and cross-foot due to rounding.

CDC has received deficiency funding in most recent years which is directly related to institution overtime costs. Generally, when correctional officers are called in or kept over from their current shifts to backfill officers using leave, these officers are paid overtime; typically the most senior (who are paid at higher rates) are given first call, further ratcheting up the cost. A change to a provision in the most recent Bargaining Unit 6 Memorandum of Understanding has reduced CDC management's ability to manage or track sick leave usage or increased overtime costs.



Appendix IV

Encumbrance Increases: June 30, 2000 to June 30, 2001

Department	Increase Amount	Department Main Reason(s) for Increase
Energy Resources Conservation & Development Commission	\$196,543,640	Legislation increased funding for energy efficient programs due to energy crisis.
Office of Criminal Justice And Planning	\$141,633,433	Office no longer exists. Reason for encumbrance increased unknown. Records currently being reviewed by DOF.
Department of Water Resources	\$122,178,408	Legislation increased funding for CALFED Bay-Delta Program.
Department of Parks and Recreation	\$78,697,020	One time appropriation for deferred maintenance of \$157,000,000.
Board of Corrections	\$78,634,620	Execution and awarding of several multi-year local assistance contracts.
Wildlife Conservation Board	\$60,060,399	Increase in capital outlay projects.
State Coastal Conservancy	\$59,031,253	Increase legislative funding for local assistance & capital outlay programs.
Caltrans	\$58,724,129	Increased funding for local assistance & capital outlay Mass Transportation.
Department of Health Services	\$58,477,534	Couldn't provide an answer. Dollar amount immaterial compared to total appropriation.
California Youth Authority	\$27,023,183	Construction projects & youth shelter contracts.
Department of Forestry and Fire Protection	\$26,733,856	Aircraft encumbrances of \$22.8M & mobile equipment of \$4.3M.
State Water Resources Control Board	\$19,896,218	Increase in appropriation of \$37.5M for current and new programs.
Secretary of State	\$8,736,106	Business Programs Automation Project.

Source: State Controller's Office Encumbrance Report
Listed department's budget unit.



Appendix V

Encumbrance Balances at June 30, 2003

Department	Encumbrance Balance	Process(es) for Monitoring Encumbrances
Department of Water Resources	\$213,090,330	BSA has performed special audits of encumbrance balances in FYs 2001–02 and 2002–03. Also audited by OSAE and DWR's internal audits office. Division of Fiscal Services monitors internally via reports.
Board of Corrections	\$77,280,386	Never been audited. Accounting monitors via monthly encumbrance reports.
Department of Parks and Recreation	\$61,551,486	Audited by internal auditors. Monitored by department accounting office.
Office of Criminal Justice and Planning	\$55,830,339	Office no longer exists. OSAE is currently reviewing records.
Energy Resources Conservation & Development	\$52,728,838	Periodic audits by OSAE. Monitored by department accounting office.
State Coastal Conservancy	\$50,263,789	Never been audited. Monitored by department accounting office.
Judicial	\$34,902,476	Didn't respond to survey.
Department of Forestry and Fire Protection	\$34,782,867	Never been formally audited. CALSTARS monthly reports to program managers for monitoring.
State Water Resources Control Board	\$31,241,095	OSAE recently reviewed encumbrance policies as part of an internal control audit. Accounting monitors via CALSTARS encumbrance reports.
California Youth Authority	\$25,329,484	Never been audited. Monitored by accounting office.
Department of Health Services	\$17,950,244	Annual audit by BSA and internal auditors. Monitored by department accounting office.
Caltrans	\$16,706,559	Annual audit by BSA and internal auditors. Monitored by department accounting office.
Secretary of State	\$15,423,167	Never been audited. Monitored internally by budget office as part of the year-end process.
Public Utilities Commission	\$14,326,347	Never been audited. Monitored by accounting office.

Source: State Controller's Office Encumbrance Report
Departmental Budget Units



Appendix VI

Existing Financial Systems Attributes

Interviews were conducted with 14 agencies. Interviews included representatives of the Accounting Office, the Budget Office and the Information Technology Office for financial systems. Agencies selected for the sample included departments using CALSTARS, enterprise systems, and other types of systems. The interviews focused on internal controls, risks, reliability, stability, economy and efficiency of the financial systems of the agencies sampled. Our findings were summarized into the major categories listed below.

- 93 percent of the departments' business needs are not met by the existing systems;
- 93 percent have significant concerns with maintaining the existing systems;
- 93 percent have staff recruitment and retention concerns and related risks;
- 93 percent rely on staff manual processing activities to ensure the integrity of financial data;
- 93 percent manually prepare two financial statements each year: one for legal/ budgetary basis and one for Generally Accepted Accounting Principles (GAAP) basis;
- 81 percent did not have an audit of their financial management systems;
- 79 percent receive federal funding and almost half of them cannot meet the federal criteria;
- 79 percent must gather data from multiple sources and manually compile reports;
- 78 percent do not have a system to capture the costs of providing a service or product (activity based costing or product costing);
- 71 percent of state agencies do not have an enterprise or strategic plan that addresses financial management systems;
- 71 percent of state agencies do not have integrated financial data (common database); data is generally handled multiple times in multiple systems;
- 57 percent of the core financial management systems are over 20 years old;
- 50 percent did not complete a department IT risk analysis; an additional 25 percent did not know if a risk analysis was performed for the systems they manage;
- 46 percent do not have a consolidated fixed (capital) asset system; and
- 29 percent were concerned with system security, the state has not established statewide security standards.



Appendix VII

Top Concerns of Departments Sampled About Financial Management Systems

The departments interviewed for the survey were asked to share their top concerns and issues that they believed were critical to financial management systems. Concerns that were identified multiple times by different individuals and by different departments are summarized below. Some issues repeat the interview attributes identified in the report; but, agency staff also identified them as their most urgent concerns. The percentage shown indicates the number of agencies who identified the item as a top concern or priority.

- 100 percent identified recruitment, retention, classification, hiring process or hiring restrictions a top concern;
- 100 percent expressed concern and frustration for the continued deferral or recognition of administrative and financial management system funding requirements;
- 85 percent identified a concern with the continuing ability or difficulty to maintain the existing system (staffing, technology, and resource issues);
- 77 percent are concerned with system obsolescence and the related risks of system obsolescence;
- 77 percent identified a need to replace their current system with a consolidated, integrated system to meet accounting and reporting requirements;
- 62 percent identified a critical need for additional knowledge skill sets for their staff;
- 54 percent want improved or increased statewide standards in accounting, budgeting and information technology;
- 54 percent identified concerns with internal controls and data integrity;
- 39 percent identified a concern with the ability to meet federal reporting requirements;
- 39 percent identified improvements must be made to the project approval and funding process;
- 33 percent expressed concern of the lack of automation and reengineering at the control agencies and the direct impact on the departments ability to make improvements;
- 31 percent want customer service improvements, economies, and/or efficiencies with the consolidation of some state services;
- 23 percent identified concerns with agency and state leadership;
- 15 percent identified employee morale and job satisfaction;
- 15 percent identified the continuous affect of legislative actions.



Appendix VIII

State of California Enterprise Financial Systems Summary of Lessons Learned

Enterprise financial systems have been implemented by several state agencies. Because this type solution is a fairly new concept to state agencies, we thought it pertinent to obtain the opinion of representatives of several of those organizations relating to their enterprise solution lessons learned. We selected five state agencies that have implemented financial enterprise solutions and interviewed representatives of their Accounting Office, Budget Office and Information Office for financial systems. We have summarized their common concerns and issues below.

- Do not underestimate the project—without previous experience, enterprise project efforts and resources are underestimated.
- Learn and understand the software before you begin the project. The project team cannot configure the system to maximize the ability of the software without this knowledge. Business users must become intimate with the software and data; do not rely on technical staff.
- Reengineer the department as part of the project. The department must be supportive of the change.
- Do not customize the system, reengineer processes or make other business changes. Many customizations were control agency requirements or formats. To avoid customizations, the control agencies must participate in the reengineering process.
- Configure the system to meet the departments “new” business needs versus the old processes.
- Accounting and business knowledge and analytical skills are critical. Differentiate between staff that may be good at the existing processes versus accounting and business knowledge. Additional training may be required.
- User participation, dedication, and business drivers are critical.
- Validate cost estimates.
- Avoid overly aggressive schedules; for a department-wide implementation a schedule of less than a year is not realistic.
- Anticipate employee turnover; all employees will not embrace the new technology or the changes in business processes.
- Anticipate new business needs and possible new functions, for example: continuous software upgrades and patches are a significant workload; comprehensive and integrated testing must always be performed; establish a dedicated functional unit that can maintain the system. Existing state classifications should be reviewed.
- Prepare and recognize changes in duties, responsibilities, and relationships in all areas involving the software.

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- The system integrates data and as a result integrates staff; actions affect multiple organizational areas.
 - The learning curve is very steep; it can take two years to become proficient on the system. Training requirements are greater than anticipated because complexity is greater than anticipated.
 - Train users in new processes at the same time you train in the new software.
 - Keep all validations turned-on; these are the controls that effect data integrity.
 - Map data and functions; “clean” existing data before any conversion.
 - Run parallel with the old and the new system; it is additional workload but worth the effort.
 - Consultants and state employees have a different frame of reference. Transfer of knowledge is two directional. Select a good consultant partner, but don’t exclusively rely on consultants.
 - Implement all the modules—not just some—they really do integrate.



Appendix IX

Other Public Sector Enterprise Financial Systems Summary of Lessons Learned

An Internet search was conducted to determine if there are other lessons learned that the state should know about, if considering enterprise solutions. Lessons learned were obtained from various source documents and the selection included universities, county, state and federal government entities. Common concerns identified reflect many of the same concerns identified by our selection of California state agencies utilizing enterprise financial solutions.

- Limit customizations and scope. Do not change the underlying programming code or allow scope creep. Modifications can greatly increase the cost of subsequent upgrading and can also affect module functionality and/or integrations.
- Do not underestimate the costs of an ERP. In addition to direct costs, a large cost will accrue from personnel—project staff, back-filled staff, consultants, recruiters, project managers, raises, training and mentoring, ongoing maintenance and upgrades.
- Changes in current business processes are often needed and recommended as a result of an ERP. Do as much prep work as possible in advance of the implementation. Make sure that all users have input into the redesign of their processes.
- There should be a core implementation team. Designate at least one person from each business unit to become a configuration expert for the module(s). Full-time, dedicated staff should be assigned to the project team. Each functional area should come to the project with a good understanding of reporting needs, work schedules, technology tools available and needed, etc.
- The ERP learning curve can be lengthy. If the process is handled badly, retirements and transfers of key people can result.
- Make sure staff is trained. ERPs are complex; so, give serious consideration to the type and timing of training.
- You have to have a strong ERP champion and work hard to build a constituency among the various participating agencies. Steering committees have proven to be beneficial in cutting through red tape, making policy decisions and resolving conflicts.
- Make sure you grow your own expertise. Hiring consultants can get very expensive.



Appendix X

Other States' Oversight and Monitoring of Performance

State & Audit Entity	Audit Roles/Functions
Arizona Office of Auditor General	The Auditor General's Office conducts audits at the request of its Joint Legislative Audit Committee, which oversees all audit functions of the Legislature. Audits include the following: <ul style="list-style-type: none"> ✓ Performance audits to determine whether an agency is achieving its objectives and managing resources efficiently/effectively ✓ Sunset audits to help Legislature determine whether or not an agency should continue ✓ Program Evaluations to assess a program's effectiveness and evaluate whether desired outcomes are being achieved
Oregon Department of Administrative Services (DAS)	The DAS includes divisions, offices, and Boards, including those that oversee the performance auditing functions, as follows: <ul style="list-style-type: none"> ✓ The Oregon Progress Board is an independent state planning and oversight agency responsible for monitoring the strategic plan. The Board developed formal state Benchmarks and Guidelines on performance measures. State agencies are required to perform internal monitoring and reporting of their performance measures. ✓ A Performance Measure Workgroup reviews agency key performance measures to assure adherence to criteria. ✓ Budget/management and Legislative fiscal offices review requests to modify performance measures.
Texas State Auditor's Office (SAO)	The State Auditor's Office reviews agencies' performance measures in order to: <ul style="list-style-type: none"> ✓ Assess accuracy of reported performance measures; ✓ Verify that performance measures are part of management systems that have adequate internal controls; and ✓ Examine how management uses performance information to manage operations. SAO has a Management Advisory Services Group that provides consulting services to agencies including the following: <ul style="list-style-type: none"> ✓ Strategic Planning, performance measurement development, program evaluation ✓ Data analysis and cost allocation ✓ Training on statistical sampling and analysis
Virginia Auditor of Public Accounts (APA)	APA's specialized Performance, Budgeting, and Forecasting Team performs tasks including the following: <ul style="list-style-type: none"> ✓ Analyzing program budgets ✓ Reviewing agencies' strategic plans ✓ Auditing agencies' performance measures
Washington Joint Legislative Audit and Review Committee (JLARC)	JLARC is a separate entity from the State Auditor's Office. It functions as follows: <ul style="list-style-type: none"> ✓ JLARC includes 1 auditor, 1 accountant, a budget analyst, administrative staff and several research analysts. ✓ Examines efficiency/effectiveness of state programs, policies and activities in key areas. ✓ Conducts objective performance audits, program evaluations, special studies, and sunset reviews and makes recommendations to the Legislature.